# ECONOMIC ASSESSMENT OF SOUTHEAST EUROPE: CATCHING-UP CONTINUES, BUT ACCESSION PROSPECTS UNCERTAIN[1]

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### *Introduction*

Southeastern Europe has only a modest deceleration of economic growth in 2005. Thus its catching-up process continues. A deterioration of the already high current account deficit is a major concern. Monetary policy is usually insufficient to deal with the problem and the exchange rate regimes are set mainly to combat inflation. Fiscal tightening is the usual policy response even if the budget deficit is low.

EU enlargement is now more uncertain than a few months ago. The likelihood increased that Bulgaria's and Romania's 2007 accession will be delayed by one year and that negotiations with Croatia and Turkey will not start this year. But until now there is no new policy decision on the part of the EU, while the accession and candidate countries are increasing efforts to meet requirements thus keeping to the agreed schedule.

The region under discussion in this paper includes the two EU accession countries Bulgaria and Romania, two candidate countries, Croatia and Turkey and the other countries of the Western Balkans, all-aspiring for EU membership. We shall refer to nine countries, treating Serbia and Montenegro separately because in economic terms they are already two countries, they form neither a customs nor a currency union and have separate fiscal policies; in addition, their statistics are separated. Also due to statistical reasons, our analysis excludes Kosovo. Turkey is for the first time integrated into the Southeast European region with which it shares common aspirations to become EU member. The statistical information on SEECs is generally much narrower and less reliable than for the NMS with the partial exception of Bulgaria, Croatia, Romania and Turkey.

### *Catching-up continues*

The Southeast European countries (SEECs) are definitely less developed than the new EU members in terms of GDP per capita in PPP. According to the most recent calculation, in 2004 Romania was at 32% of the EU-25 average, Bulgaria at 30%, while Croatia with 46% was similar to the largest new member state, Poland. Over the last four years, these SEECs have reduced their distance to the EU-25 average, Bulgaria by three percentage points, Romania by seven and Croatia by five (Annex Table A/1). Turkey is just behind Bulgaria with 29% of the EU average but it has hardly surpassed the pre-crises year 2000 level. The rest of the Western Balkan countries are even less developed, at 25-27% of the EU-25 average, with Albania closing the row with only 20%.

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Among them Albania has been catching up most rapidly while Macedonia fell back.

Incomplete statistics for the first quarter of 2005 suggest that a solid rate of about five per cent economic growth is now present throughout the region with the exception of Croatia which grows only at below 3% (Table 1 and Fig. 1). Croatia grows even less than the NMS which points to structural weaknesses especially in the manufacturing sector. The larger of the accession countries, Romania had extraordinarily rapid growth in 2004 (8.3%) rapid structural change and improved export competitiveness. In the course of preparing for EU membership they stepped up reforms and improved the conditions of doing business. Economic growth in Serbia and Turkey, similarly to Romania, will fall out lower than in the previous year. Montenegro and Macedonia, which were lagging behind in the past, will probably benefit from accelerated growth in 2005.

Some of the countries in the region are still below their pre-transformation GDP. Only Albania, Romania and Croatia have

**Table 1**

**Gross domestic product**

real change in % against preceding year

| | 2000 | 2001 | 2002 | 2003 | 2004 1) | 2004 1st quarter | 2005 1st quarter | 2005 forecast | 2006 forecast | Index 1990=100 2004 | Index 2000=100 2004 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Albania | 7.3 | 7.6 | 4.7 | 6.0 | 5.9 | . | . | 6.5 | 6.5 | 143.9 | 126.5 |
| Bosnia & Herzegovina | 5.5 | 4.5 | 5.5 | 3.0 | 5.0 | . | . | 5 | 6 | . | 119.2 |
| Bulgaria | 5.4 | 4.1 | 4.9 | 4.5 | 5.6 | 4.5 | 6.0 | 5.5 | 5.3 | 97.7 | 120.6 |
| Croatia | 2.9 | 4.4 | 5.2 | 4.3 | 3.8 | 4.2 | . | 3 | 3 | 101.9 | 118.9 |
| Macedonia | 4.5 | -4.5 | 0.9 | 2.8 | 2.9 | 2.4 | . | 4 | 4 | 92.9 | 101.9 |
| Romania | 2.1 | 5.7 | 5.1 | 5.2 | 8.3 | 6.2 | 5.9 | 5.5 | 5.5 | 106.5 | 126.6 |
| Serbia | 4.2 | 4.8 | 3.7 | 2.6 | 7.0 | . | . | 4 | 5 | . | 119.3 |
| Montenegro | . | -0.2 | 1.7 | 2.5 | 3.0 | . | 1.9 | 5 | 5 | . | 107.2 |
| Turkey | 7.4 | -7.5 | 7.9 | 5.8 | 8.0 | 11.8 | . | 6 | 6 | 162.1 | 114.1 |

Note: 1) Preliminary.
Source: WIIW Database incorporating national statistics, forecast: WIIW

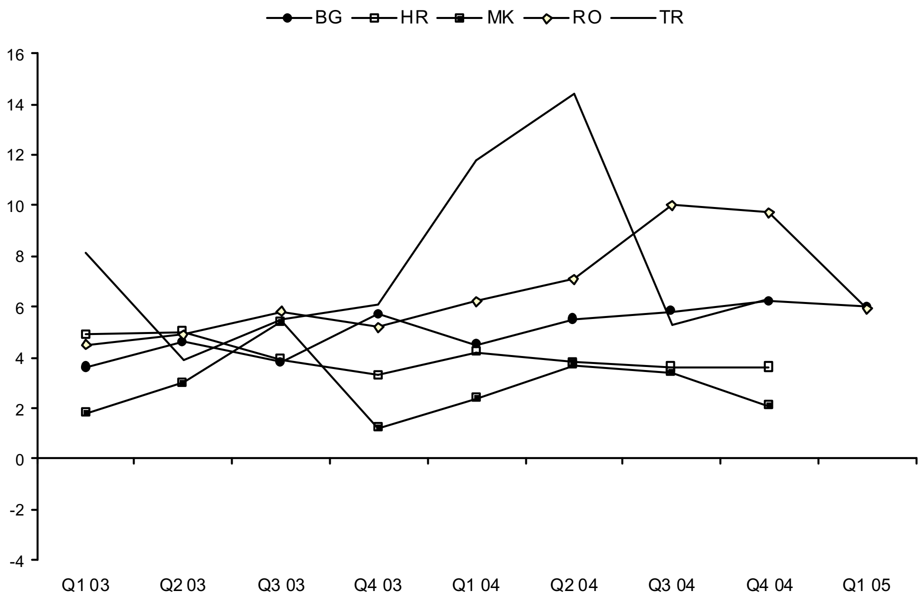
spurred by private demand and a bumper harvest which cannot be repeated. Quarterly GDP growth rates are falling in Romania while accelerating in Bulgaria. The expected 5.5% economic growth in 2005, identical in both countries, is the result of surpassed that level, Bulgaria and Macedonia are close to it. Serbia and Montenegro, also Bosnia and Herzegovina which suffered serious setbacks in the 1990s still have a long way to go, especially since their growth performance has not been higher than that of the other countries in the region. Institutional reforms and structural changes are still on the way and large amounts of investments would be necessary to modernize infrastructure. Without such reforms, foreign and domestic private investments cannot grow rapidly.

Gross fixed capital formation grew most rapidly in Bulgaria, Romania and Turkey, at double digit pace in 2004, promising fast future economic growth and structural change (Table 2). But in the first quarter of 2005 in all these countries it fell short of the pre-year rate and a deceleration of investment activities is forecast for 2005. In the two accession countries foreign direct investment reached record amounts in 2004 supporting privatisation and economic growth (Table 10). More modest inflows are forecasted for 2005[2]. Turkey is different, as fixed capital formation has, despite recent fast growth, just reached the pre-crisis level of the year 2000. Continuing rapid expansion of investments is predicted. But this country is still less open to FDI, which may delay the inflow of new technology and know-how. Beside these countries, only Croatia publishes national accounts conforming international standards which show that the construction boom is over and fixed capital formation slowed down in 2004.

**Figure 1**

**Quarterly GDP, 2003-2005**

real change in % against preceding year




Source: wiiw Monthly Database incorporating national statistics.

[2] *See for details: wiiw database on foreign direct investment in Central, East and Southeast Europe 2005. May 2005*

**Table 2**

**Gross fixed capital formation**
real change in % against preceding year

| | | | | | | | | | | Index | Index |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | 1990=100 | 2000=100 |
| | 2000 | 2001 | 2002 | 2003 | 2004 1) | 2004 | 2005 | 2005 | 2006 | 2004 | 2004 |
| | | | | | | 1st quarter | | forecast | | | |
| Bulgaria | 15.4 | 23.3 | 8.5 | 13.9 | 12.0 | 22.1 | 9.2 | 8 | 10 | 144.3 | 170.7 |
| Croatia | -3.8 | 7.1 | 12.0 | 16.8 | 4.4 | 8.9 | . | 4 | 4 | . | 146.3 |
| Macedonia | -1.5 | -8.6 | 17.6 | 1.1 | . | . | . | . | . | . | . |
| Romania | 5.5 | 10.2 | 8.2 | 9.1 | 10.1 | 7.3 | 5.2 | 7 | 8 | 154.6 | 143.2 |
| Serbia 2) | 13.3 | -4.1 | -0.8 | . | . | . | . | . | . | . | . |
| Turkey | 16.9 | -31.5 | -1.1 | 10.0 | 35.0 | 57.6 | . | 25 | 15 | 154.4 | 100.5 |

Notes: 1) Preliminary. - 2) Gross fixed investment.
Source: wiiw Database incorporating national statistics, forecast: wiiw.

Private demand gave the main pull to economic growth in both EU accession countries in 2004 and also in the first quarter of 2005. This is true first of all for Romania where domestic demand, primarily that of households, grew by 12% (Bulgaria 5%). As outlined in the section on wages below, Romania has had particularly rapid wage expansion, while Bulgaria showed more restraint last year but less in the current election year. Government final consumption had a modest positive contribution to growth in Bulgaria and Romania in 2004, and it can be even less in 2005 in Romania while increasing in Bulgaria. As the trade deficit widened, net exports have most probably had a negative contribution to growth in both countries.

Domestic demand and export expansion fuelled the increase of industrial output in Romania and Bulgaria both in 2004 and in the first quarter of 2005 (Table 3). Manufacturing recovers this year also in Macedonia after a severe decline in the previous one. Stagnation of the industry in Croatia and its decline in Serbia are signs of structural change but also of problematic industrial competitiveness in both countries. Privatisation to insiders has not proved advantageous as capital investments are inadequate and access to foreign markets is limited. Foreign takeovers are rare and investors are generally not keen to enter into joint ventures in Croatia. Serbia relies more on privatisation by sale, and the present decline in industrial output may be due to restructuring which can be followed by an upswing. Traditionally, the Turkish private economic activity concentrated in the primary and tertiary sectors. Industrialization was the government's job and has remained halfway. Now, the secondary sector is growing rapidly, backed by alliances between private domestic and foreign forces. In all countries of the region, with the exception of Bulgaria, services are more dynamic than industry and a construction boom is also widely present.

**Table 3**

**Gross industrial production**

real change in % against preceding year

| | | | | | | | | | | Index | Index |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | | 1990=100 | 2000=100 |
| | 2000 | 2001 | 2002 | 2003 | 2004 [1) ] | **2004** | **2005** | **2005** | **2006** | | **2004** |
| | | | | | | **1st quarter** | | **forecast** | | | |
| Albania [2)] | 0.5 | 7.1 | 1.8 | 2.7 | 3.1 | . | . | 4 | 5 | 43.8 | 115.4 |
| Bosnia and Herzegovina | 7.9 | 4.9 | 5.7 | 5.1 | 12.1 | . | . | 7 | 10 | . | 130.6 |
| Bulgaria [3)] | 8.3 | 1.5 | 6.5 | 14.1 | 18.3 | 14.8 | 11.1 | 10 | 8 | 77.4 | 146.0 |
| Croatia | 1.7 | 6.0 | 5.4 | 4.1 | 3.7 | 5.6 | 0.3 | 2 | 3 | 77.4 | 120.6 |
| Macedonia | 3.0 | -3.1 | -5.3 | 4.7 | -2.2 | . | 4.8 | 3 | 5 | 49.7 | 94.0 |
| Romania | 7.1 | 8.3 | 4.3 | 3.1 | 5.3 | 5.9 | 5.3 | 5 | 5 | 75.2 | 122.7 |
| Serbia | 11.4 | 0.1 | 1.8 | -3.0 | 7.1 | 9.5 | -3.4 | 3 | 5 | . | 105.9 |
| Montenegro | 4.3 | -1.0 | 1.1 | 2.1 | 13.8 | -1.7 | 3.9 | 5 | 5 | . | 116.2 |
| Turkey | 6.0 | -7.5 | 9.4 | 7.8 | 9.8 | 10.4 | 6.2 | 6 | 8 | 181.1 | 119.7 |

Notes: 1) Preliminary. - 2) According to gross value added. - 3) For quarterly data- enterprises with more than 10 employees.
Source: wiiw Database incorporating national statistics, forecast: wiiw

Based on the above trends one can conclude that in 2005 Southeast Europe is expected to grow somewhat less dynamically than in 2004. A deceleration of growth characterizes first of all the largest economies of the region, Turkey, Romania, Croatia and Serbia. Only two smaller countries, Macedonia and Montenegro that were lagging behind earlier will likely grow faster. There are indications, that in most countries both investments and private consumption grow slower than in the previous year. Public consumption will decline further and net exports may become even more negative. Growth deceleration will not stop the catching-up process as all countries but Croatia will grow at a rate between 4% and 6% in 2005 and probably also in 2006.

### *Inflation coming down, wages low but increasing*

Inflation has been low or slightly descended in seven countries of the region increasing only in Croatia and Serbia (Table 4). Fixed exchange rates and widespread euroization mean that most prices of tradables follow the European trend and hardly increase. Bosnia-Herzegovina and Macedonia have enjoyed price stability for some time; inflation is low and decreasing in Albania. It is also low in Croatia but in 2005 it will probably increase in comparison to the previous year. Romania and Turkey have the highest rate consumer price increase, but inflation is coming down below 10% this year. In Romania where wages have expanded very rapidly, one cannot observe an acceleration of inflation albeit the growth of government administered energy prices. But prices not covered by the consumer price index, like those of new dwellings, skyrocketed in the last few years. The acceleration of inflation in Serbia, which started anew last year, continued in the first quarter of 2005. This can be associated with the rapid expansion of wages and the generated demand as well as with currency depreciation.

Real wages have increased in many countries of the region quite rapidly in recent years (Table 5). In Albania, Romania and Serbia they increased at or close to double digit pace and this trend even accelerated in the first quarter of 2005. Wage expansions are far more rapid than the increase of GDP and may support inflation or a deterioration of the trade balance.

Relatively low euro wages are the advantage of Bulgaria when it comes to attracting labour intensive manufacturing. Romania has lost some of its attractiveness after the recent wage rises and appreciation of the local currency (Annex Table A3). Albania and Serbia also have low wages, but other factors of doing business are not favourable. In countries whose currencies are fixed and wages increase rapidly, wages are significantly higher in euro terms compared to the rest of the region. Therefore production is more costly than in the rest of region in Bosnia and Herzegovina, in Croatia and in Montenegro. These countries will probably not attract labour intensive export oriented manufacturing FDI and will have to find an alternative growth path if the current trend holds on.

**Table 4**

**Consumer price inflation**

change in % against preceding year

| | 2000 | 2001 | 2002 | 2003 | 2004 [1] | 2004 | 2005 | 2005 | 2006 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | 1st quarter | | forecast | |
| Albania | 0.1 | 3.1 | 5.2 | 2.3 | 2.9 | 3.9 | 2.2 | 2.5 | 2.5 |
| Bosnia & Herzegovina [2] | 4.8 | 3.1 | 0.4 | 0.6 | 0.4 | 0.4 | . | 0.5 | 0.5 |
| Bulgaria | 10.3 | 7.4 | 5.8 | 2.3 | 6.2 | 6.4 | 3.8 | 4 | 4 |
| Croatia [3] | 6.2 | 4.9 | 1.7 | 1.8 | 2.1 | 1.8 | 3.3 | 3 | 2.5 |
| Macedonia | 5.8 | 5.5 | 1.8 | 1.2 | -0.4 | 1.6 | -0.4 | 2 | 2 |
| Romania | 45.7 | 34.5 | 22.5 | 15.3 | 11.9 | 13.6 | 8.8 | 9 | 7 |
| Serbia | 79.6 | 93.3 | 16.6 | 9.9 | 11.4 | 8.6 | 16.0 | 15 | 10 |
| Montenegro [2] | 22.9 | 22.8 | 17.6 | 7.8 | 3.3 | 6 | 3.6 | 3 | 3 |
| Turkey | 54.9 | 54.4 | 45.0 | 25.3 | 10.6 | 9.5 | 8.6 | 8 | 6 |

Notes: 1) Preliminary. - 2) Retail prices. - 3) Up to 2001 retail prices.
Source: wiiw Database incorporating national statistics, forecast: wiiw

**Table 5**

**Real net wages**
change in % against preceding year

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | 1st quarter | |
| Albania 1) | -0.2 | 9.9 | 17.7 | 11.6 | 8.1 | 6.0 | 11.2 | | . | . |
| Bosnia & Herzegovina 1) | . | 9.7 | 4.0 | 14.8 | -0.6 | 7.3 | . | | . | . |
| Bulgaria 1) | 20.7 | 6.9 | 1.3 | -0.5 | 1.5 | 3.7 | -1.9 | | 0.0 | 5.5 |
| Croatia | 6.0 | 10.1 | 3.4 | 1.6 | 3.1 | 3.8 | 3.7 | | 4.3 | 1.7 |
| Macedonia | 3.8 | 3.6 | -0.3 | -1.9 | 5.0 | 3.6 | 4.4 | | 2.1 | 2.9 |
| Romania | 3.4 | -3.8 | 4.6 | 4.9 | 2.1 | 10.7 | 9.5 | | 9.0 | 13.1 |
| Serbia | . | . | 5.5 | 16.5 | 29.9 | 14.0 | 11.1 | | 5.0 | 16.5 |
| Montenegro | . | . | . | . | . | 9.3 | 9.6 | | . | 5.7 |
| Turkey 2) | . | . | -3.9 | -23 | -10.9 | 11.9 | 1.0 | | 3.4 | . |

Notes: 1) Real gross wages. - 2) Real gross wages in manufacturing industry.
Source: wiiw Database incorporating national statistics.

***Unemployment high and hardly changing***

Low participation and high unemployment rates are lasting characteristics of the Western Balkans (Table 6)[3]. The situation is worst in Bosnia and Herzegovina, where about 40% of the workforce is registered jobless, but the real unemployment rate had there been a labour force survey could be about half of that. In Macedonia the strict stabilization policy has depressed output and employment. The unemployment rate peaked at 37% in 2004 and is expected to decline slowly as a result of resumed economic growth in 2005. The situation is still much better in Serbia but the restructuring of the economy triggers an increase in unemployment also in this country. Serbia is now heading towards 20% rate of unemployment where Bulgaria was five years ago. The latter country embarked on a more rapid economic growth path after privatising and restructuring most of the economy, thus the unemployment rate is now coming down towards 10%. But the participation rate is 56% in Serbia while below 50% in Bulgaria - a perhaps only temporary advantage of Serbia.

The lowest unemployment rate together with a relatively high participation rate can be found in Romania. Fast economic growth has increased employment, mainly in construction and trade. Unemployment stagnates at about 8% despite major layoffs when former state owned enterprises are restructured. A lasting problem is the severe underemployment in rural areas. Low rate of unemployment and hidden underemployment is a problem in Turkey as well and the overall employment situation is worse than in Romania. The participation rate is very low and unemployment increases slowly due to demographic reasons despite the fast economic growth rate.

*3 We do not have exact knowledge either about the size of illegal employment and or about the importance of underemployment in the public or socially owned sector - therefore it is unclear whether official unemployment statistics under or overestimate the problem. All data are according to the labour force survey except for Albania and Bosnia and Herzegovina.*

**Table 6**

**Labour market, LFS definition, annual average rate in %**

| | Participation rate | | | Unemployment rate | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 1) | 2002 | 2003 | 2004 1) | 2004 | 2005 | 2005 | 2006 |
| | | | | | | | 1st quarter | | forecast | |
| Albania 2) | . | . | . | 15.8 | 15.0 | 14.4 | 14.9 | . | 14 | 14 |
| Bosnia & Herzegovina 2) | . | . | . | 40.9 | 42.0 | 42.8 | . | . | 42 | 42 |
| Bulgaria | 49.4 | 49.2 | 49.7 | 17.8 | 13.7 | 12.0 | 13.3 | 11.3 | 10.3 | 9.5 |
| Croatia | 50.9 | 50.2 | 50.5 | 14.8 | 14.3 | 13.8 | . | . | 13.5 | 13 |
| Macedonia | 52.6 | 54.5 | 52.2 | 31.9 | 36.7 | 37.2 | 37.2 | . | 35 | 35 |
| Romania 3) | 56.0 | 54.8 | 54.8 | 8.4 | 7.0 | 8.0 | 8.8 | . | 7 | 7 |
| Serbia | 56.1 | 55.7 | 56 | 13.3 | 14.6 | 18.5 | . | . | 20 | 20 |
| Montenegro | . | . | . | 21.6 | 22.9 | 22.3 | . | . | 23 | 23 |
| Turkey | 49.6 | 48.3 | 48.7 | 10.3 | 10.5 | 10.3 | 12.4 | 11.7 | 10.8 | 11 |

Notes: 1) Preliminary. - 2) Unemployment by registration, end of period. - 3) From 2002 new methodology in accordance to EU definitions.
Source: wiiw Database incorporating national statistics, forecast: wiiw.

On the whole, unemployment is stubborn in the whole region but prospects are not altogether bad. The examples of Bulgaria and Romania, to some extent also of Albania show that employment can increase in the presence of very high rates of economic growth. Unfortunately we do not expect such employment-creating development in the rest of the region.

***Foreign trade and current account deficits expand***

High and growing foreign trade deficit is a major characteristic of South East European countries. Although exports have grown quite rapidly in some of the countries, imports have grown even faster. Exports to GDP ratio, an indicator of openness is low, below 40% except for Bulgaria, the lowest in Albania, 8% in 2004 (overview table III). Indicators around or below 25% for Serbia, Croatia, Montenegro and Bosnia-Herzegovina indicate that the export sector is very weak and the manufacturing sector is slow to recover. As to the import side, openness is pathologically high in case of Bosnia-Herzegovina, 81%, and above 50% in not only Bulgaria but also in Macedonia and Montenegro. High import dependence together with a low ability to export adds up to a large foreign trade deficit.

The deficit of goods trade in the balance of payments is the lowest in Turkey (8% of GDP in 2004), Romania (9%) and Bulgaria (14%) (Table 7). The trend has been increasing in all three countries over the last few years. The accession countries boast with high rates of exports expansion and deepening integration into the EU. But their economic growth is import intensive, partly due to investment goods and raw materials that come from abroad, partly due to growing demand for consumer goods. Especially Romania's imports have been boosted by soaring demand of private consumers driven by rising wages. In addition, a large part of the manufacturing exports is wage processing with low value added. First quarter 2005 data confirm the trend of rising foreign trade deficits in Bulgaria and Romania (Table 8, calculated in nominal euro). In these countries both exports and imports growth accelerated compared with the previous year. Turkey seems to switch to a healthier trend with imports growing less than exports in the first quarter but the two growth rates may become more similar later in the year and in absolute terms the trade deficit will continue to widen.

Five other countries of the region have a trade deficit between 20% and around 30% of GDP (Table 7). The lower end is represented by Albania where exports rise impressively albeit from a very low level. Serbia has the highest deficit and largest increase in 2004 but this will be corrected in 2005 as the growth rate of exports will likely exceed that of imports (Table 8). The same is true for Montenegro. In Croatia the foreign trade deficit came down somewhat in 2004 but it is on the rise again in 2005.

In all countries, the current account deficit is fortunately much smaller than the trade deficit of goods (Tables 7 and 9). Some countries have very positive balances of services. From tourism Croatia has the most significant earnings and these are also rising

**Table 7**

**Current account**
in % of GDP, based on EUR

| | Balance on goods | | | Balance on services | | | Balance on incomes | | | Balance on transfers | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | **2002** | **2003** | **2004** | **2002** | **2003** | **2004** | **2002** | **2003** | **2004** | **2002** | **2003** | **2004** |
| Albania | -23.9 | -21.9 | -19.6 | -0.1 | -1.4 | -0.6 | 2.6 | 2.8 | 2.2 | 12.9 | 13.7 | 13.6 |
| Bosnia & Herzegovina | -59.2 | -58.4 | -55.4 | 3.3 | 3.7 | 4.5 | 9.1 | 7.5 | 5.4 | 24.6 | 22.7 | 22.2 |
| Bulgaria | -10.2 | -12.5 | -14.0 | 2.9 | 3.0 | 3.7 | -1.7 | -3.2 | -1.8 | 3.4 | 3.5 | 4.6 |
| Croatia | -24.6 | -27.3 | -24.3 | 13.6 | 19.8 | 17.7 | -2.4 | -4.2 | -2.2 | 4.8 | 4.9 | 4.3 |
| Macedonia | -21.3 | -18.4 | -20.9 | -0.6 | -0.1 | -0.8 | -0.8 | -0.7 | -0.7 | 13.2 | 15.9 | 14.7 |
| Romania | -5.7 | -7.8 | -9.0 | 0.0 | 0.1 | -0.4 | -1.0 | -2.4 | -2.3 | 3.3 | 4.0 | 4.2 |
| Serbia | -24.7 | -24.2 | -31.7 | 1.9 | 1.5 | 1.8 | -0.7 | -1.1 | -1.0 | 10.0 | 12.1 | 15.3 |
| Montenegro | 32.7 | 25.1 | 28.1 | 7.6 | 7.8 | 9.1 | 5.8 | 6.9 | 6.8 | 6.7 | 3.2 | 2.9 |
| Turkey | -4.0 | -5.8 | -7.9 | 4.3 | 4.4 | 4.2 | -2.5 | -2.3 | -1.8 | 1.3 | 0.4 | 0.4 |

Source: WIIW Database incorporating national statistics.

in Montenegro. As a result, services trade shows an 18% of GDP surplus in Croatia and 9% in case of Montenegro in 2004. While it seems that the Croatian tourism revenues have levelled out, there is some room for increase in the latter country. Turkey has a large tourism industry, but net services revenues amount only to 4.2% of GDP, similar to Bosnia and Herzegovina or Bulgaria.

Another major foreign revenue for several countries comprises transfers, i.e. remittances of people working abroad. In 2004 transfers amounted to 22% of GDP in case in Bosnia and Herzegovina, 15% for Macedonia and Serbia and 14% for Albania. They are on the increase in Serbia while stagnating or falling in the other countries. Emigration and foreign employment of Bulgarian and Romanian citizens is of smaller scale and more recent than from the former Yugoslav countries; transfers of earnings from abroad are constantly growing and amount to 4-5% of GDP. Turkish data on transfers, 0.4% of GDP, are very modest if compared with the large size of diaspora in Europe. But there is a huge amount of unclassified capital inflow in the balance of payments booked as errors and omissions, in part hiding remittances.

**Table 8**

**Foreign Trade**

cumulated data within respective period, based of customs statistics

| Exports total (fob) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | I Q 2003 | I-II Q 2003 | I-III Q 2003 | I-IV Q 2003 | I Q 2004 | I-II Q 2004 | I-III Q 2004 | I-IV Q 2004 | I Q 2005 |
| Albania | EUR mn | 101 | 204 | 303 | **401** | 109 | 238 | 360 | **486** | 121 |
| | change in % | 16.5 | 23.8 | 19.7 | **14.7** | 7.8 | 16.8 | 18.9 | **21.3** | 11.1 |
| Bosnia & Herzegovina | EUR mn | 260 | 602 | 955 | **1303** | 357 | 760 | 1197 | **1677** | . |
| | change in % | 9.0 | 15.5 | 14.7 | **11.5** | 37.3 | 26.2 | 25.4 | **28.7** | . |
| Bulgaria | EUR mn | 1635 | 3252 | 5004 | **6668** | 1719 | 3618 | 5807 | **7994** | 2078 |
| | change in % | 20.5 | 15.0 | 10.9 | **10.0** | 5.1 | 11.3 | 16.0 | **19.9** | 20.8 |
| Croatia | EUR mn | 1364 | 2696 | 4002 | **5468** | 1452 | 3042 | 4727 | **6451** | 1491 |
| | change in % | 15.5 | 6.8 | 4.2 | **5.4** | 6.5 | 12.8 | 18.1 | **18.0** | 2.7 |
| Macedonia | EUR mn | 274 | 588 | 890 | **1206** | 293 | 598 | 960 | **1343** | 364 |
| | change in % | -1.6 | 4.0 | 1.5 | **2.4** | 6.9 | 1.7 | 7.9 | **11.4** | 24.4 |
| Romania | EUR mn | 3778 | 7501 | 11574 | **15614** | 4337 | 9033 | 13995 | **18935** | 5091 |
| | change in % | 14.4 | 8.2 | 7.6 | **6.4** | 14.8 | 20.4 | 20.9 | **21.3** | 17.4 |
| Serbia | EUR mn | 576 | 1173 | 1812 | **2397** | 544 | 1228 | 2033 | **2943** | 753 |
| | change in % | 22.3 | 18.4 | 14.1 | **11.0** | -5.5 | 4.7 | 12.2 | **22.8** | 38.4 |

| Imports total (cif) | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | I Q 2003 | I-II Q 2003 | I-III Q 2003 | I-IV Q 2003 | I Q 2004 | I-II Q 2004 | I-III Q 2004 | I-IV Q 2004 | I Q 2005 |
| Albania | EUR mn | 384 | 802 | 1218 | **1648** | 380 | 827 | 1302 | **1851** | 417 |
| | change in % | 4.6 | 5.1 | 5.2 | **3.6** | -1.0 | 3.0 | 6.9 | **12.3** | 9.7 |
| Bosnia & Herzegovina | EUR mn | 1045 | 2332 | 3654 | **4974** | 1051 | 2421 | 3855 | **5354** | . |
| | change in % | 3.5 | 8.2 | 8.7 | **6.0** | 0.6 | 3.8 | 5.5 | **7.6** | . |
| Bulgaria | EUR mn | 2084 | 4541 | 6933 | **9611** | 2412 | 5330 | 8204 | **11617** | 2959 |
| | change in % | 17.1 | 17.1 | 16.5 | **14.3** | 15.8 | 17.4 | 18.3 | **20.9** | 22.7 |
| Croatia | EUR mn | 2752 | 5982 | 9176 | **12546** | 2919 | 6483 | 9855 | **13338** | 3076 |
| | change in % | 12.5 | 9.9 | 10.2 | **10.8** | 6.1 | 8.4 | 7.4 | **6.3** | 5.4 |
| Macedonia | EUR mn | 496 | 1009 | 1499 | **2037** | 493 | 1087 | 1665 | **2332** | 530 |
| | change in % | -2.1 | 0.0 | -0.6 | **-3.3** | -0.6 | 7.8 | 11.1 | **14.5** | 7.4 |
| Romania | EUR mn | 4541 | 9814 | 15129 | **21201** | 5482 | 11992 | 18644 | **26281** | 6642 |
| | change in % | 9.3 | 10.5 | 10.6 | **12.3** | 20.7 | 22.2 | 23.2 | **24.0** | 21.2 |
| Serbia | EUR mn | 1531 | 3117 | 4692 | **6484** | 1893 | 3996 | 6099 | **8852** | 1667 |
| | change in % | 14.0 | 14.1 | 10.9 | **11.0** | 23.6 | 28.2 | 30.0 | **36.5** | -12.0 |
| **Trade balance** | | | | | | | | | | |
| | | I Q 2003 | I-II Q 2003 | I-III Q 2003 | I-IV Q 2003 | I Q 2004 | I-II Q 2004 | I-III Q 2004 | I-IV Q 2004 | I Q 2005 |
| Albania | EUR mn | -283 | -598 | -915 | **-1247** | -271 | -588 | -942 | **-1365** | -296 |
| Bosnia & Herzegovina | EUR mn | -784 | -1731 | -2699 | **-3671** | -694 | -1661 | -2658 | **-3677** | . |
| Bulgaria | EUR mn | -448 | -1289 | -1929 | **-2942** | -693 | -1712 | -2398 | **-3624** | -881 |
| Croatia | EUR mn | -1388 | -3286 | -5174 | **-7079** | -1466 | -3441 | -5128 | **-6887** | -1585 |
| Macedonia | EUR mn | -222 | -420 | -609 | **-830** | -200 | -489 | -705 | **-989** | -165 |
| Romania | EUR mn | -763 | -2313 | -3555 | **-5588** | -1146 | -2959 | -4649 | **-7346** | -1552 |
| Serbia | EUR mn | -956 | -1944 | -2880 | **-4086** | -1349 | -2768 | -4066 | **-5909** | -914 |

Note: Albania, Bosnia and Herzegovina: Data refer to balance of payments statistics.
Source: wiiw Monthly Database incorporating national statistics; IMF for Albania.

Taking all the components together, we arrive to the current account deficit to GDP rate of 23% in Bosnia and Herzegovina which is sustainable only due to foreign aid and multilateral loans (Table 9). Deficit levels of 13% in Serbia, 10% in Montenegro, around 7% in three other countries, and 5% in the rest of the region can be judged in comparison with the level of external debt situation. Running a high deficit should be a lesser problem for Romania and Macedonia which have low and declining debt to GDP ratios (around 30%). But it is certainly a major problem for Croatia and Macedonia where debts piled up to 82% and 80% of GDP respectively. Even the net debt (gross debt minus National Bank reserves) of Croatia is high, 60% of GDP, which calls for a policy adjustment. High debt is due primarily to increasing private borrowing from abroad and the stability of the exchange rate discussed below.

**Table 9**

**Foreign financial position**
end of period, in % of GDP EUR based

| | Gross external debt [1] | | | | Reserves of National Bank (excluding gold) [2] | | | | Current account | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 2002 | 2003 | 2004 | | 2002 | 2003 | 2004 | | 2003 | 2004 | 2005 | 2006 |
| | | | | | | | | | | | forecast | |
| Albania | 22.0 | 20.6 | . | | 15.9 | 15.0 | 15.4 | | -6.7 | -4.4 | -5 | -4 |
| Bosnia & Herzegovina | 36.8 | 32.7 | 30.7 | | 21.2 | 22.6 | 26.6 | | -24.5 | -23.3 | -21.4 | -18.8 |
| Bulgaria | 65.1 | 60.2 | 63.0 | | 13.1 | 14.4 | 17.0 | | -9.2 | -7.4 | -7.5 | -6.4 |
| Croatia | 62.2 | 77.6 | 82.1 | | 23.3 | 25.7 | 23.3 | | -6.9 | -4.5 | -4.4 | -4.5 |
| Macedonia | 37.7 | 34.5 | 33.4 | | 17.3 | 17.5 | 15.4 | | -3.3 | -7.7 | -6.6 | -6.3 |
| Romania | 30.9 | 31.3 | 30.7 | | 12.1 | 12.6 | 18.4 | | -6.0 | -7.5 | -8.3 | -7.4 |
| Serbia | 71.2 | 64.7 | 57.9 | | 13.7 | 16.3 | 16.8 | | -9.2 | -13.1 | -14 | -13 |
| Montenegro | . | 65.7 | 80.4 | | . | . | . | | -7.4 | -9.7 | -5 | -5 |
| Turkey | 70.9 | 60.5 | 53.5 | | 13.9 | 13.4 | 11.4 | | -3.3 | -5.1 | -5 | -5 |

Notes: 1) General government foreign debt for BiH; Macedonia and Romania medium- and long-term debt. - 2) Albania: including gold; refer to total foreign assets of Bank of Albania.
Source: WIIW Database incorporating national statistics, forecast: WIIW

Turkey has in the last four years successfully come out from the default. Foreign debts to GDP are declining, the current account deficit is moderate, but reserves could be higher. The prospects for the country are quite good and one cannot expect another default. The other country of the region which went through a currency crises a few years earlier than Turkey is Bulgaria which has an improving net debt position under the currency board regime since 1997. Staying with the currency board until joining the EMS seems to be a feasible policy.

FDI could be a non-debt creating way of financing the current account deficit. This was achieved in Albania, Bulgaria and Romania in 2004 (Table 10). But inflows fluctuate year-by-year according to the availability of major privatisation deals and a high level of deficit financing is possible only as long as there are state assets to be sold.

**Table 10**

**FDI inflow to SEE, EUR million**

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | | 2004 | 2005 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | forecast | | in % CA | in % CA |
| Albania | 155 | 232 | 151 | 158 | 275 | 400 | | 95.8 | 111.1 |
| Bosnia and Herzegovina | 159 | 133 | 282 | 338 | 400 | 400 | | 25.9 | 26.7 |
| Bulgaria | 1103 | 903 | 980 | 1851 | 2114 | 1800 | | 146.1 | 112.5 |
| Croatia | 1142 | 1503 | 1195 | 1788 | 921 | 1000 | | 73.7 | 76.9 |
| Macedonia | 189 | 493 | 83 | 84 | 122 | 100 | | 36.5 | 33.3 |
| Romania | 1147 | 1294 | 1212 | 1946 | 4098 | 3500 | | 93.1 | 58.3 |
| Serbia | 55 | 186 | 502 | 1197 | 775 | 800 | | 33.1 | 32.0 |
| Montenegro | . | 11 | 89 | 39 | 50 | . | | 35.0 | . |
| Turkey | 1855 | 3684 | 621 | 367 | 2199 | 2000 | | 17.6 | 14 |

Note: CA means current account deficit.
Remarks: Albania: equity capital.
Bosnia and Herzegovina: equity capital.
Bulgaria: equity capital + reinvested earnings + loans.
Croatia: equity capital + reinvested earnings + loans.
Macedonia: equity capital.
Romania: equity capital + reinvested earnings from 2003 + loans.
Serbia: FDI net (inflow minus outflow).
Montenegro: FDI net (inflow minus outflow).
Source: National banks of respective countries according to balance of payments statistics.

***Managing the exchange rate and capital inflows***

Five SEECs have currencies with fixed exchange rates to the euro: Bulgaria and Bosnia-Herzegovina run a currency board, Macedonia and Croatia (unofficially) maintain a peg, Montenegro (and Kosovo) uses the euro as a legal tender. Four countries have more flexible exchange rate regimes. Serbia has an unannounced crawling peg system, similarly to Romania up to recently meaning that the Central Bank allows a depreciation somewhat below the consumer price index and guides the floating exchange rate towards an unannounced target. This target is given up in case of an unexpected shock like in Romania when appreciation started. This country is about to switch to even more free flotation. Inflation targeting is the name of the monetary policy now applied in Romania, Turkey and Albania which is associated with free floating exchange rate regimes.

With the fixed exchange rate countries can buy stability, but still their inflation is usually higher than in the Euro zone and the real appreciation may erode their competitiveness. More flexible exchange rate systems usually go hand in hand with higher inflation. These regimes allow the depreciation of the local currency that may help maintain international price competitiveness. But capital inflows can also appreciate a currency and thus work against the current account balance. This has been the case in Romania since October 2004 and to a lesser extent also in Albania. Also the Croatian and the Bulgarian currencies appreciated in real terms in 2004 and in the first quarter of 2005. But only Croatia has problems with exporting while the Bulgarian currency still seems undervalued. Serbia is similar to Romania of the late 1990s with inflation and depreciation supporting each other. While most of the Southeast European countries have relied on the currency peg when suppressing inflation, Romania improved fundamentals gradually, by which also inflation came down. It is to be seen what steps the Serbian authorities will take if the current trend of widening current account deficit and accelerating inflation continues.

Investment risk has declined in the accession countries and in Croatia. Appreciating currencies together with high domestic interest rates attract investments and help accumulate private sector debts (Tables 9 and 11). Looking at the composition of foreign debt one can observe the increasing share of private debt in total foreign debt in all three countries (Fig 2). Foreign banks which are the main owners of local commercial banks are especially active in borrowing abroad cheap and investing in the host country thus earning on the interest rate differential. They extend credits less to the companies than to households or buy government securities. Lending to households and mortgage loans have been striving businesses in recent years.

**Table 11**

**Exchange rate development, 2003-2005**

11a

**Nominal exchange rates per EUR, growth rate year-on-year** [1)]

| | I Q 2003 | II Q 2003 | III Q 2003 | IV Q 2003 | I Q 2004 | II Q 2004 | III Q 2004 | IV Q 2004 | I Q 2005 |
|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | | | |
| Bulgaria | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Croatia | -2.7 | -0.7 | -0.1 | 0.2 | 1.6 | 2.3 | 2.0 | 2.5 | -1.3 |
| Macedonia | 0.2 | 0.1 | 0.0 | 0.1 | 0.6 | 0.5 | 0.4 | 0.4 | 0.2 |
| Romania | 25.7 | 22.1 | 15.1 | 18.8 | 13.9 | 8.7 | 9.6 | 0.4 | -8.6 |

Notes: 1) Quarterly data are averages of monthly rates.
Source: wiiw Monthly Database incorporating national statistics.

11b

**Real rates per EUR, PPI based - growth rate year-on-year** [1)]

| | I Q 2003 | II Q 2003 | III Q 2003 | IV Q 2003 | I Q 2004 | II Q 2004 | III Q 2004 | IV Q 2004 | I Q 2005 |
|---|---|---|---|---|---|---|---|---|---|
| Bulgaria | -5.6 | -2.4 | -3.4 | -3.7 | -1.5 | -4.8 | -4.5 | -3.2 | -2.6 |
| Croatia | 0.1 | 1.0 | 0.9 | 2.4 | 0.6 | -2.5 | -3.7 | -3.0 | -2.8 |
| Macedonia | 0.6 | 2.2 | 2.7 | 2.9 | 2.9 | 1.9 | 1.0 | 1.2 | 1.3 |
| Romania | 4.8 | 2.4 | -1.6 | 0.0 | -3.3 | -7.2 | -7.0 | -12.2 | -16.7 |

Notes: 1) Minus means real appreciation.
Source: wiiw Monthly Database incorporating national statistics.

11c

**Real rates per EUR, CPI based - growth rate year-on-year** [1)]

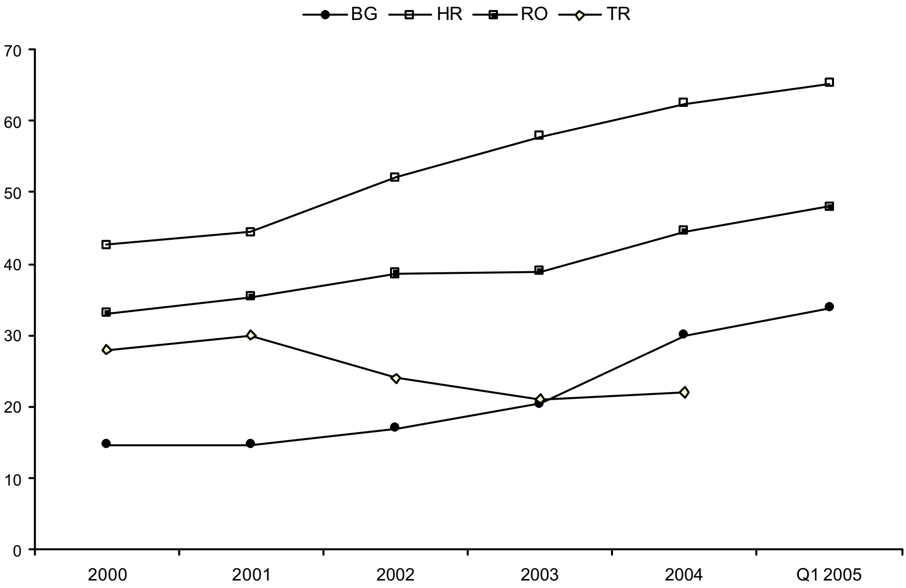
| | I Q 2003 | II Q 2003 | III Q 2003 | IV Q 2003 | I Q 2004 | II Q 2004 | III Q 2004 | IV Q 2004 | I Q 2005 |
|---|---|---|---|---|---|---|---|---|---|
| Bulgaria | 2.0 | 1.2 | -0.7 | -2.3 | -4.2 | -4.0 | -4.0 | -2.1 | -1.4 |
| Croatia | 2.5 | 3.1 | 2.2 | 2.9 | 0.5 | -1.3 | -1.0 | -0.8 | -2.0 |
| Macedonia | 1.0 | 0.6 | -0.6 | 0.0 | -0.2 | 1.9 | 2.0 | 1.9 | 1.9 |
| Romania | 10.5 | 8.7 | 2.3 | 5.6 | 2.2 | -0.8 | 0.4 | -6.3 | -13.9 |

Notes: 1) Minus means real appreciation.
Source: wiiw Monthly Database incorporating national statistics.

**Figure 2**

**Share of private foreign debt in total foreign debt, 2000-2005**

in per cent




Source: National banks of respective countries.

Central banks are concerned about the excessive capital inflows and the fast increase of lending to the population. Capital inflows increase the current account deficit or if not sterilized they can increase inflation. But with currency boards or pegged exchange rates in place, central banks have very few monetary policy instruments at hand. Bulgaria and Croatia try to influence the credit activity of the commercial banks by raising the reserve requirements. Romania was concerned about the domestic credit expansion early last year and increased the lead interest rate. Later on the authorities became more concerned about capital inflows and worked on lowering the interest rate. The absence or limited availability of monetary policy instruments together with a fixed or appreciating exchange rate puts the burden of adjustment on the fiscal policy.

***Fiscal policy tight***

Fiscal consolidation has been a primary target throughout the region with the aim to cure high current account deficits, while only two countries have also high budget deficits. Albania and Croatia have general government deficits more than 4.5% of GDP, the rest of the countries have deficits of less than 2%, Bulgaria is running a surplus (Table 11). Budgetary austerity is the IMF-led government programme irrespectively of the size of budget balance. In the long run this policy has been very helpful to introduce fiscal discipline and improve transparency but in individual cases it proved to be over ambitious or even counterproductive.

Under the currency board regime in Bulgaria there is hardly any other tool in the hands of the authorities to curtail the current account deficit and the inflationary pressure than working on the government generated demand. The fiscal surplus over the last few years helped the country reduce its public debt from the level of default to a level earning constantly improving sovereign credit ratings. Fast structural reforms helped the country embark on a sustainable economic growth path which affected increased budgetary revenues. But expenditure tightening has curtailed public services, depressed wages and pensions and contributed to the low standard of living. The wage increases introduced at the beginning of this year despite the objections of the IMF have actually not reduced the surplus of the budget. Also Romania was at row with the IMF over the compensation of lost revenues due to the introduction of a 16% flat tax at the beginning of 2005. Also here, revenues from other sources grew fast enough to keep the deficit within the modest limit of 1 per cent of GDP.

In Croatia the public deficit is a more pressing problem. It has been high for several years and has contributed to the soaring external indebtedness. The government planned to bring down the deficit from close to 5% of GDP in 2004 to 3.7% in 2005. This seems quite impossible if only due to the deceleration of economic growth and in midyear the government has most probably softened the target. Transparency of the budget is another acute problem and methodological improvement is necessary before a more exact judgement can be made. This is certainly true also for many other countries in the region.

Macedonia has been the example of successful fiscal consolidation bringing down the deficit from over 6% of GDP in 2001 to 1% in 2004. Arriving to a healthy budget has suppressed economic growth. Now that the resumption of growth is the main aim, the government seems to lack ideas how to stimulate growth without falling back on the fiscal side. Serbia is a more recent example of a similar budgetary consolidation policy. It has brought down the general government deficit from 4.2% of GDP in 2003 to 1.7% in 2004. The IMF programme stipulates a surplus for 2005. Fiscal austerity is a vehicle to speed up structural reforms in the still too large public sector and to press for privatisation. Subsidies and inefficient employment are to be reduced. The short-term effects of this programme have already shown up in the increasing rate of unemployment while exports recovered and economic growth accelerated.

Turkey is on an even stricter programme of the IMF, which has supported its recovery from the 2001 crisis. Budget deficit has been brought down from 16% of GDP to 8% in 2004 while it has a primary surplus of 6% of GDP. The difference is the interest payment on the huge public debt the country is servicing. Similar to the transition economies, privatisation revenues should help bring down government debt.

***EU enlargement now more uncertain***

Accession to the European Union in 2007 is the main goal for all political forces in Bulgaria and Romania. Also other governments in the region target EU accession in the closer or more remote future. This aspiration contributes to enforcing structural reforms and may increase political stability as well. But the European sentiment towards further EU enlargements has cooled down recently.

The outcome of the referenda on the EU constitution in France and the Netherlands interrupted the process of deepening the integration and also questioned the usefulness of further enlargements. An ebb of the integration process may start a re-thinking of the future of the European integration and solutions to pending issues may be further delayed. Dates and conditions of further enlargements could come under renewed consideration and political goodwill may no longer tolerate the lack of preparedness.

Having signed the accession treaty on April 25, 2004, Bulgaria and Romania can feel pretty safe over their future in the EU. Unilateral withdrawal of the EU from this contract is unlikely. Still there are at least two major hurdles on which the accession of the two countries on 1 January 2007 may stumble. One is the annual assessment by the Commission; the other is the ratification of the accession treaties in the parliaments of the member states.

The European Commission is expected to provide the next screening of Bulgaria and Romania in November 2005 and will detail the most sensitive aspects of the current situation. This report is expected to determine whether Bulgaria and Romania should join in 2007 or 2008. Meanwhile early warning letters arrive in the two capitals reminding the governments of areas in which further efforts are necessary. There are several chapters including competition where the governments may get a bad mark[4]. If inadequate preparedness is stated, the safeguard close by which accession would be postponed to 2008 will probably come into effect. The probability of this has increased. Following the negative referenda on the European Constitution, the Commission will be more accurate when judging the conditions in the accession countries.

Accession delayed by one year would do not much economic harm to Bulgaria and Romania. It could in fact be used for further preparation and increasing competitiveness. While they would not be eligible for increased funds from the EU budget, their ability to draw on these funds may increase. The loss in transfers would amount to EUR 1.16 bn for Romania but only under the unlikely condition it would be able to exploit all these funds. For sure there would be disappointment in both accession countries if they do not prepare for delayed accession in due time. At the same time, delayed enlargement would come at hand for many incumbent governments. It would be albeit minor relief in the 2007-2013 EU budget that may make a compromise with the net payers easier. Some incumbent governments may also reap domestic political benefits by supporting an enlargement delay. The negative political sentiment towards enlargement in some incumbent countries may also postpone the ratification of the two accession treaties. This may not only delay accession by one year but, postpone enlargement for good. What seemed to be very unlikely just a few months ago became a real possibility under the new political circumstances.

The renewed discussion on enlargement hits all other countries in the region. Especially Turkey which was promised to get the lengthy accession

[4] *The accession treaty refers to a list of policy areas (11 for Romania and 7 for Bulgaria) in which the two countries must make significant progress before accession. In Romania, the main issues are corruption, border controls, the enforcement of state aid controls and the implementation of environmental laws. In Bulgaria, the concerns centre around judicial reforms, agriculture, environment (including the closure of the Kozloduy nuclear power plant), intellectual property rights and the free movement of services.*

negotiations started as of October 2005 may have to suffer a delay. Croatia is another official candidate country. Its prospects are better as it can start the negotiation process provided cooperation with the Hague Tribunal is found satisfactory.

For countries in the Western Balkans that have made sufficient progress in terms of political and economic reform and administrative capacity, the next step is a formal contractual relationship with the EU. This takes the form of a tailor-made Stabilization and Association Agreement (SAA). To keep the process of preparation for enlargement going is essential for longer-term political stability and continued reform efforts in the region. Macedonia has already the SAA and may get a candidate status soon. In order to get the SAA, the Serbian government first of all has to improve cooperation with the Hague Tribunal. It has further the task of adopting a national strategy of accession to the EU. The unresolved status of Kosovo and the uncertain future of the union with Montenegro are additional constitutional problems that have to be solved. In Bosnia and Herzegovina local authorities do not appear enthusiastic to meet EU conditions necessary for concluding an SAA. The Serb-dominated part of the country (RS) rejected recently one of the conditions, the creation of a countrywide police force. While the lack of fulfilling political conditions seems to be the major delaying factor to sign SAAs, only a deepening cooperation with the EU and the prospect of membership can stimulate governments to solve the pending problems, guarantee stability and create conditions for sustainable economic development.