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## INFLATION DEVELOPMENTS IN ROMANIA

Since April 2007, disinflation tendency in the newly acceded country, Romania seems to be stagnated. This process can be explained mainly by supply-side factors. On the other hand, inflation remains below the target (of 4 percent with the 1 percentage point tolerance band) of the National Bank of Romania. The annual inflation rate declined to 4.56 percent in June 2007 from 5.37 percent in March.

### BACKGROUND

In August 2005, the National Bank of Romania has changed the applied monetary regime and shifted to inflation targeting. In the inflation targeting system, national banks have a direct inflation target, which they try to reach with a tolerance band. There is no indirect aim. In case the inflation targeting system is successful, the inflation target is able to anchor the inflation expectations. As the main indicator in this system is the expectation, the communication with the general public and transparency of the monetary policy and its institutions are more accented in comparison with other monetary systems.

In Romania the inflation targeting system based on CPI and the target sets as a midpoint, announced by the government and the national bank, within a band of  $\pm 1$  percentage point. The National Bank of Romania has set its inflation target for 2007 at 4% with the tolerance band of 1 percentage point.

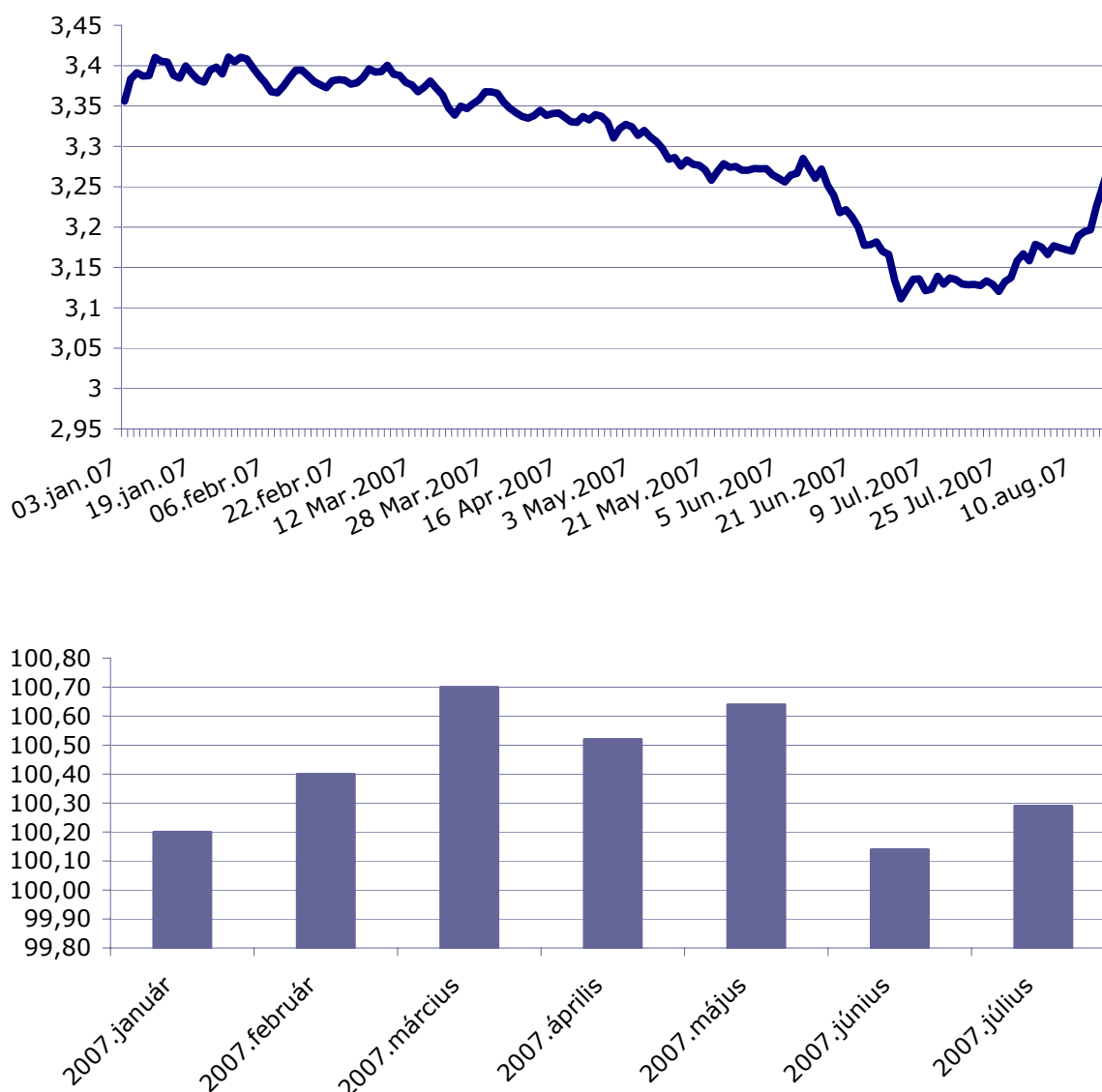
### FACTS

#### *Inflationary effects:*

- The main effects are the supply side factors, because of the summer drought – as in so many countries around Europe. The supply shortfall was followed by increasing fruit- and vegetables' prices.
- Another inflationary factor can be the more-than-expected slowdown of gross domestic product growth. Decreasing supply and enhancing demand on the market leads consumer prices grow up. The private consumption' dynamic continued to fall, but has still 11.3 percentage growth year by year. Investment continued to be the fastest-growing component of domestic demand, but its growth rate also has slowed marginally from 18 to 17.2 percent.
- High wage rises also an important component of the price-performance
- The interest rate developments also affected the inflation. A trend change can be realized in February 2007, till there is an easing monetary policy period (see the Chart 1.)

CHART 1.

## DAILY EXCHANGE RATES AND MONTH ON MONTH INFLATION DEVELOPMENTS IN ROMANIA



Source: National Bank of Romania

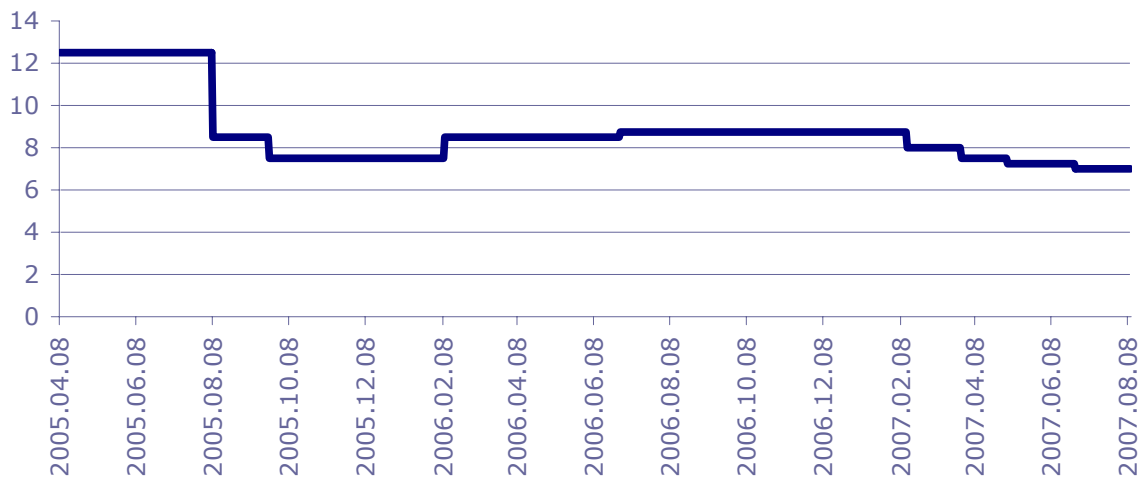
### Disinflationary effects:

- The national currency of Romania, the leu was appreciating against the euro more than expected to around 3.12 RON/EUR in the late June and was stable at this level till the end of July (see the Chart 2.). As the inflation and the exchange rate have a very close relationship with each other, changes in any of them will have a strong effect on the other indicator. In the case, the exchange rate (expressed as national currency per unit of foreign currency, in Romanian Leu per unit of foreign currency) is appreciating; the domestic firms and consumers must pay less for the imported goods; thus it leads to disinflation.
- The European Union accession of Romania in 2007 went together with some new, temporary disinflation effects, which could let Romanian inflation rate declining. One of

them is the elimination of import duties on intra-community trade, which was followed by spread price cuts. On the other hand, on the retail market a stronger competition was developed after the accession.

- Value added taxation (VAT) payment system changes.
- Aggregate demand declining.

**CHART 2. INTEREST RATE DEVELOPMENTS IN ROMANIA**



Source: National Bank of Romania

### FURTHER DISINFLATION RISKS

"Against the background of the current quarterly forecasting round, the NBR Board took the necessary steps to substantiate and set the 2009 inflation target, which the Government also assumed. Following the assessment of the various projection scenarios and of their underlying key assumptions, the 2009 inflation target was set at 3.5 percent with the 1 percentage point tolerance band, considering the need to continue disinflation over the medium run, in manner consistent with the timetable for euro adaptation and taking into account the risks and uncertainties surrounding medium-term inflation, especially those related to factors outside the central bank's sphere of influence."<sup>1</sup>

The National Bank of Romania identifies four main risks in the Inflation Report of August, which could break the disinflation trend in the Romanian inflation:

- Further rapid wage increases, which exceed the productivity gains; thus wage earnings could exacerbate consumer demand. On the other hand, the wage hikes could generate higher costs
- There is a risk in the government sector as well, by a fiscal policy easing step; where the current budget deficit exceeded the programmed level
- Exchange rate risk, which could be generated by the lei's sizable depreciating. As we look at the exchange rate chart, we realize a trend change in the time series from August, when the RON – hand in hand with the currencies of the neighbour-countries – began to weaken up to 3.28 RON/EUR.

<sup>1</sup> Inflation report, 2007 August, National Bank of Romania

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- The fourth main risk derives from widening external imbalances, as a result of persistently fast-growing domestic absorption.

The success of the future achievement of inflation target depends on the aforementioned risks and other unpredictable internal and external shocks, thus the target of 4 percent for 2007, 3.8 for 2008 and 3.5 for 2009 will be reached only by a good monetary policy, which uses efficient instruments to navigate expectations.

## FLAT TAX REFORM IN MACEDONIA

On 1<sup>st</sup> January 2007 Macedonia introduced a flat-rate tax of 12 percent on both personal and corporate income. On 1<sup>st</sup> January 2008 the government plans to cut the rate to 10 percent and by this measure the country will achieve one of the lowest tax rates in the world. The new tax system replaces the former 17 percent corporate tax rate on profits and personal tax ranging from 15 to 24 percent. The other elements of the current reform are the elimination of the tax on reinvested profits and the zero-taxation of personal allowances. The latter implies that a dual-rate personal income taxation is adopted: not all income below a certain threshold (basic allowance) is taxed, whereas all income above it is taxed at the single rate.

By realising the tax reform Macedonia joins the group of those almost exclusively former Soviet Union or former Soviet Bloc nations which have introduced the flat-rate tax system since the middle of the 1990s<sup>2</sup>. Among them there are several countries - the so-called 'flat tax tigers' - which experienced booms after the introduction of the flat tax system (e.g. Estonia, Lithuania, Latvia, Slovakia). However the source of prosperity in these countries is a hotly-debated issue as the introduction of flat taxes had been part of a wider economic reform in all cases. The limited empirical evidence to date is hardly conclusive either in this regard, or on whether the adoptions of the flat-rate tax systems achieved their original objectives. In the case of a given country a closer examination of the theoretical advantages and the evaluation of the country's specific characteristics are needed in order to get a clear picture of the possible effects of the tax reform.

The introduction of flat-rate tax in Macedonia is part of an overall economic reform ('Revival in 100 steps') which was introduced by the newly elected rightist government in July 2006. The general aim of the overall reform is to end the long-term recession that began after the independence in the 1990s.

**TABLE 1. REAL GDP GROWTH RATE IN MACEDONIA, 1995-2006 (%)**

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006*
-1,1	1,2	1,4	3,4	4,3	4,5	-4,5	0,9	2,8	4,1	3,8	4,0

*Source: Eurostat, \*: all recent data subject to revision*

As Table 1 shows there were two turning points in the real GDP growth throughout the last decade. At first the economic decline in the aftermath of the disintegration of Yugoslavia turned into a positive trend in 1996 due to the government's stabilization program, which was initiated in the end of 1994 with the assistance of international donors. Then in 2001 the recovery of the economy came to a halt with the armed conflict between the government and ethnic Albanian rebels. As a consequence the rate of real GDP growth remained below 5% throughout the past decade and with this data Macedonia lags behind several SEE countries.

The general object of boosting economic growth includes the necessity of remedying the three weakest points of the Macedonian economy: the high unemployment (the official unemployment rate was 35,9%<sup>3</sup> in 2006), the low volume of FDI (1,7% of GDP in 2005, 6%<sup>4</sup> of GDP in 2006 which increase was mainly due to the ongoing privatisation process) and the wide-spread corruption (according to its corruption perception index Macedonia had the 105<sup>th</sup>

<sup>2</sup> Estonia (1994), Latvia (1995), Lithuania (1996), Russia (2001), Serbia (2003), Slovakia (2004), Ukraine (2004), Romania (2005), Georgia (2005), Iceland (2007), Mongolia (2007), Kyrgyzstan (2007), Macedonia (2007) – the year of the flat-rate tax reform in parenthesis

<sup>3</sup> Source: Eurostat

<sup>4</sup> Source: Eurostat

position in 2006 in a survey of 163 countries, among the SEE countries only Albania had a worse result with being at the 111<sup>th</sup> place<sup>5</sup>).

According to the theoretical effects of a flat-rate tax reform and the experiences of other countries the introduction of a single, low rate of tax may remedy both the problem of the low volume of FDI and high unemployment in the case of Macedonia because it creates stronger incentives for productive behaviour.

The encouragement of investment – domestic but particularly foreign – may operate through the simplification of tax rules. The tax reform has an important role at this point as although the inflow of FDI has been strengthened throughout the last decade in Macedonia, its inflow has been volatile and its volume has been low compared to the other SEE countries.

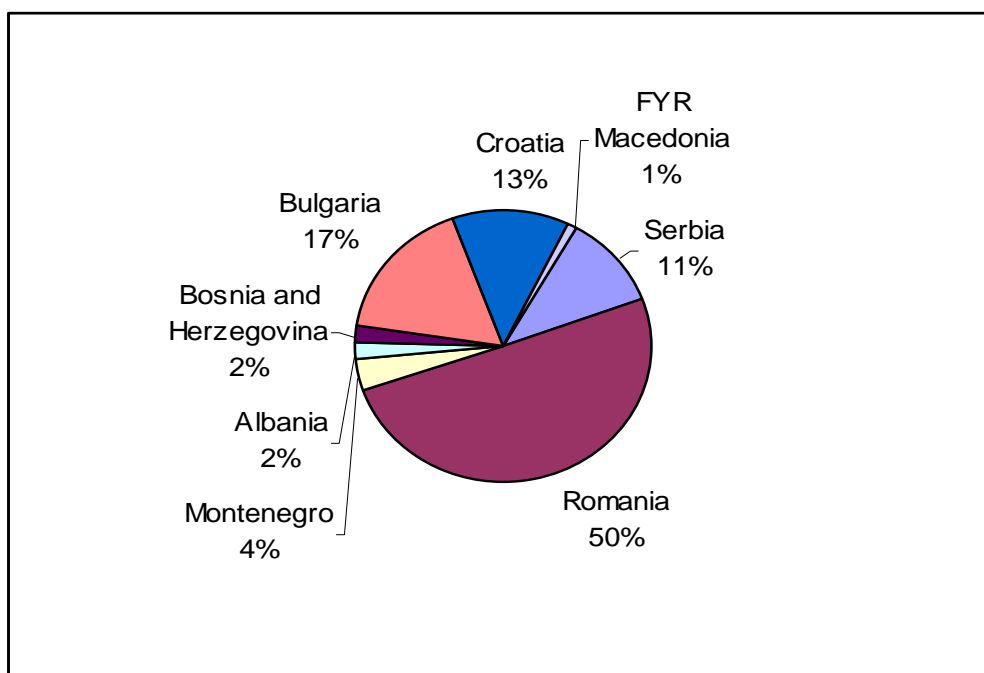
**TABLE 2. INWARD FDI IN MACEDONIA (EUR MILLION, 1995-2005)**

1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005
7	9	27	114	31	189	493	83	81	127	79

*Source: Eurostat*

As Graph 1 shows within the group of SEE-8 most of the FDI flows into the EU member or candidate countries. In 2005 half of the FDI inflow was directed to Romania, 17% to Bulgaria, 13% to Croatia, 15% to Serbia and Montenegro, while the other three countries gained only 5% of the total FDI inflow.

**GRAPH 1. FDI INFLOWS BY COUNTRIES (2005, SEE-8=100%)**



*Source: central banks of the countries, WIIW*

In Macedonia total FDI amounted to only 2,9% of GDP in 2004 and 1,7% of GDP in 2005. In 2006 the volume of FDI inflows had considerably increased - and thus reached 6% of projected GDP - due to the privatization process in the energy sector and several Greenfield investments in the free economic zones. These positive developments are likely to characterize also the

<sup>5</sup> Source: Transparency International



coming years as attracting FDI inflows to Macedonia is one of the top priorities of the new government, thus beside the tax reform other pro-investment measures were taken: legislation has been enacted that ensures equal treatment of foreign investors versus domestic counterparts, numerous incentives have been provided (e.g. the right for foreign investors to freely transfer and repatriate investment capital and profits) and a number of Free Economic Zones (FEZ) have been set up that provide additional benefits to foreign investors. Nevertheless the positive effect of the tax reform and the provided incentives is diminished by the restrictive monetary policy which discourages investment by setting high interest rates.

As mentioned before the introduction of the flat tax is also expected to decrease the high unemployment rate by reducing labour costs thus giving investors more incentives to develop the human capital of the firms. However the introduction of the flat tax only lightens the symptom but does not cease the cause of the high unemployment. As a significant proportion of the labour is unqualified, the only solution for the long-run is to provide them the possibility to obtain more skills and qualifications. The official unemployment rate was 40% in 2005 then it slightly decreased to 35,9% in 2006. Although the real figure is around 25% - once those employed in the shadow economy are subtracted - this proportion is still excessively high. The tax reform may have an important role also at this point as it leads to the reduction of employment costs which in turn encourages the businessmen to register their employees. The flat tax is expected to be an incentive for numerous entrepreneurs to legalize their businesses.

Besides attracting foreign investment, decreasing unemployment and repressing shadow economy, the introduction of the flat-rate tax may contribute to the recovery of the Macedonian economy in other ways as well. The tax changes are likely to stimulate competitiveness in the economy and thus stimulate exports. Another possible consequence is the so-called Laffer-effect: the government revenues may grow because the introduction of flat tax makes tax compliance more attractive. However when considering the repressing effect of flat taxes on tax evasion and thus on government revenues in Macedonia, it worth to take into consideration the results of an IMF study<sup>6</sup> which found that on the one hand in certain cases (e.g. Russia) it had been mainly the strengthening of the tax administration that resulted in a substantial increase in tax compliance and on the other hand in the case of the 'second wave' countries (which introduced flat taxes after Russia) the reforms generally seem to have caused a decrease in personal-income tax revenues that has not been fully offset either by changes in taxpayers' behaviour or by increases in other types of taxes.

The foregoing have shown that the flat tax reforms do not seem to have uniform and unambiguously strong positive effect but as it may be a device of boosting the economy a growing number of countries decide to adopt this system. In the SEE region the first country to introduce a flat-rate tax was Serbia, which replaced its former three-rate, graduated personal income tax system with a flat rate of 14%. On the one hand the single rate is imposed on labour income, and income from agriculture, forestry, and self-employment, previously taxed at 20%. On the other hand, the corporate profit tax rate was also reduced from 20% to 14%, giving Serbia one of the lowest corporate profit tax rates in Europe. The next reformer was Romania where the single rate of 16% was introduced in 2005. In this case the single rate replaced the former personal income tax which imposed five rates and it also reduced business profits tax from 25%. The spreading of the flat tax system has considerably accelerated this year as Macedonia introduced the 12% single rate on 1st January and it was followed by Montenegro and Albania a half year later. Montenegro has just adopted a 15% flat tax on personal income and a corporate profits tax rate of 9% on 1st July. By 2010 the country will have a unified flat tax of 9% on both personal and corporate income which will be one of the world's lowest flat taxes. Albania replaced its old, five-rate system with a 10 percent flat tax on personal income on 1st July and it will introduce the 10% rate on corporate income (instead of the former 20%) only on the 1st January 2008. The government stated that by this step it intends to attract more FDI, increase the competitiveness of the economy, repress the shadow economy and simplify tax collection. As the wave spreads over the region, Albania is not the last one for a while to adopt flat tax system: The Bulgarian government already cut corporate

<sup>6</sup> Keen et al: The 'Flat Tax(es)': Principles and Evidence, IMF Working Paper, WP/06/218

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tax to 10% on 1st January 2007 moreover it has recently announced that it will introduce a flat tax of 10% on personal income as well in 2008. Croatia is currently in the midst of national debate about the tax reform.

According to the evidence the pressure of fiscal competition urged the above-mentioned countries to introduce or to think over the adoption of flat tax systems. As new countries have entered the club the earlier adopters were forced to lower their rates (especially in the case of corporate income) which induced the further spread of the competition. In the coming years it may be expected that first the competition will become increasingly intensive and then the incentives for adoption may be weakening as the flat-tax club increases in size.

## INFORMATION SOCIETY IN THE WESTERN BALKAN AND IN TURKEY: A GENERAL OVERVIEW

The role of information and communication technologies (ICT) in economic growth and social change has gained importance in recent years. The level of production, diffusion and use of ICT are considered as major sources of economic development. Both Information Society Technologies (IST) use and ICT production sector are of high priority in Information Society developments.

Not surprisingly, in accordance with their general development level in the Southeast European countries are at a relatively early stage in the development of information society. Information technology infrastructure in these countries is mainly underdeveloped and production of ICT as well as the usage of information technologies related services stays at a relatively low level. However, they are lagging behind the more matured European countries; there are strengths in most economies in order to catch up with Eastern European EU members.

### THE PLACE OF SOUTHEAST EUROPEAN INFORMATION SOCIETIES IN THE WORLD

Information society developments and performances are measured by different benchmarking indices. The Network Readiness Index used by the World Economic Forum measures the degree of preparation of a nation to participate in and benefit from ICT developments.<sup>7</sup> According to the Network Readiness Index the Southeast European countries perform very different.

**TABLE 3. GLOBAL INFORMATION SOCIETY RANKINGS**

	HR	TR	RO	BG	ME	RS	MK	BA	AL	HU
<b>Network Readiness Index (2006/07)</b>	46	52	55	72	74*	74*	81	89	107	33
<b>Digital Opportunity Index (2005/06)</b>	48	52	50	47	61	70	67	64	107	36
<b>ICT Opportunity Index (2005)</b>	45	67	55	71	78*	78*	73	77	106	40

*Source: NRI – World Economic Forum, DOI and IOI – World Information Society Report 2007*

*Notes: \*Serbia and Montenegro are ranked together*

On the one hand, Turkey and Croatia performs better than some EU members, such as Poland, Romania or Bulgaria, on the other hand, Albania, the Former Yugoslav Republic of Macedonia and Bosnia and Herzegovina are far behind the European countries. While Croatia, Romania, Bosnia and Herzegovina, Montenegro and Serbia made good progresses in 2006 and 2007, Bulgaria and Turkey fell back significantly compared to the previous year. Almost the same situation can be observed in the case of Digital Opportunity Index<sup>8</sup> (DOI) and the ICT Opportunity Index<sup>9</sup>. Digital Opportunity Index was better in Croatia than in Greece or Poland in 2005-06, while the fYR of Macedonia and Serbia had considerably lower DOI scores in the

<sup>7</sup> The NRI is composed of three component indices, which assess:

- environment for ICT offered by a country or community
- readiness of the community's key stakeholders (individuals, business and governments)
- usage of ICT among these stakeholders.

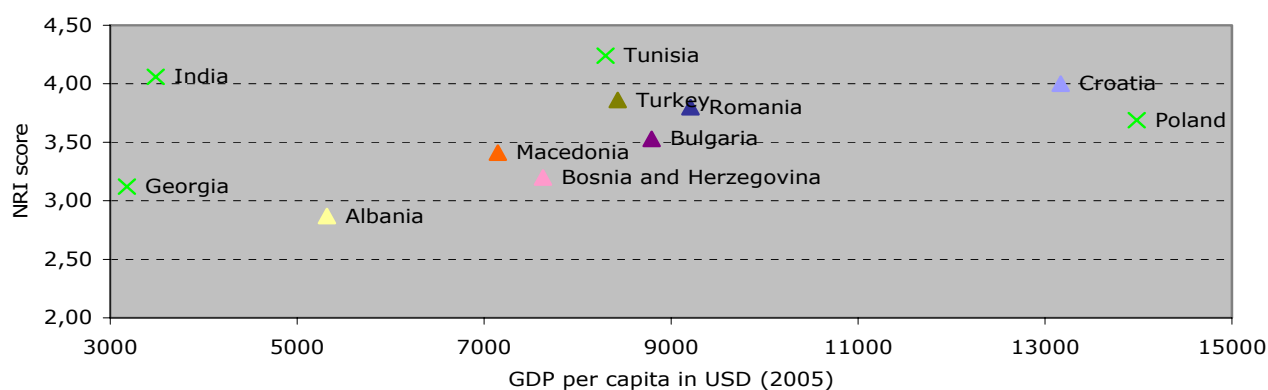
<sup>8</sup> Digital Opportunity Index is a composite index comprising eleven separate indicators, grouped in three clusters of opportunity, infrastructure and utilization.

<sup>9</sup> The building blocks of the ICT Opportunity Index are info-density and info-use and their components ICT infrastructure, ICT skills, ICT uptake and ICT intensity of use.

global scale. Again, considering the ICT Opportunity Index, Croatia and Romania are above the average<sup>10</sup>, whereas the remaining Western Balkan economies rank below the average.

An interesting link can be explored between GDP per capita and IS indices. Having a closer look at the NRI results one could find that for example Tunisia with a GDP per capita of USD 8298<sup>11</sup> has an NRI score of 4.24 and is ranked 35 overall. Turkey, Romania, Bulgaria and Croatia with similar or even higher GDP per capita have lower NRI scores. India with a significantly lower GDP per capita (USD 3486) performs much better than the Southeast European countries. It reveals from the global rankings that Albania holds a bad position regarding IS developments. For example several least developed countries (Mali and Uganda) and developing countries with significantly lower GDP per capita perform better than Albania considering the general macroeconomic, regulatory and infrastructural environment for ICT as well as the degree of usage of ICT by individuals, business and public sector.

**CHART 3. NETWORK READINESS INDEX VS GDP PER CAPITA**



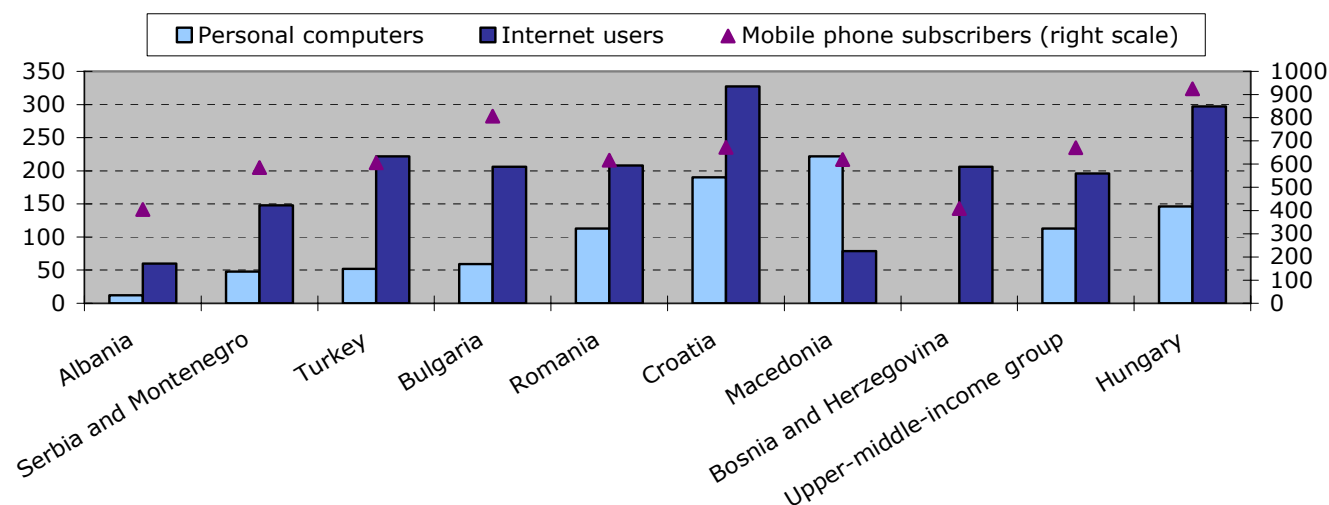
Source: World Economic Forum, UNSTAT

### ACCESS AND USE OF ICT

Level and quality of ICT infrastructure is far behind in the Southeast Europe compared to more matured European countries. Access to personal computers is at a relatively low level, however most SEE countries show better results in the case of Internet users than the upper-middle-income group average. Moreover, Croatia performs better than certain NMS if taking into account computer access and Internet usage. Number of mobile phone subscribers increased significantly in all countries in recent years.

<sup>10</sup> Average of 183 economies in the global ranking

<sup>11</sup> GDP per capita, current international dollars (PPPs) (WB estimates, 2005)

**CHART 4. PERSONAL COMPUTERS, INTERNET USERS AND MOBILE PHONE SUBSCRIBERS PER 1 000 INHABITANTS (2005)**

Source: World Bank, *ICT at a Glance Tables*; Notes: Data for Serbia and Montenegro together; no data are available for number of computers in the case of Bosnia and Herzegovina

While almost half of the NMS-10<sup>12</sup> households are equipped with computers and more than one third of all households have Internet connection, computer penetration rate reached only 21-25-26% in the Bulgarian, Macedonian and Romania households. Level of Internet access and broadband access in households are also far behind the NMS-10 averages<sup>13</sup>. The degree of computer technology equipment and Internet access at the enterprises is also below the EU averages, however the gap is not so remarkable in the case of business sector. It is noteworthy that access to computer and Internet is especially underdeveloped in rural areas. Low level of ICT infrastructure in households, at enterprises and public institutions hinders all sectors in the region to benefit from advantages of modern technologies, getting digital contents and usage of e-services.

**TABLE 4. ICT PENETRATION INDICATORS IN SELECTED COUNTRIES**

2006	BG	RO	TR	MK	NMS-10	EU27
Percentage of households with computer access	21	26	12	25	49	60
Percentage of households with Internet access	17	14	8	14	39	50
Percentage of households with broadband access	10	5	2	1	24	30
Percentage of enterprises with computer access	89	77	...	...	94	96
Percentage of enterprises with Internet access	75	58	8	14	88	92
Percentage of enterprises with broadband access	57	31	...	...	61	73

Source: Eurostat

## DIGITAL CONTENTS AND E-SERVICES

Typically, general low level of ICT infrastructure assumes low quality and low usage level of digital contents and e-services. Usage of Internet services are considerable low in Bulgaria, Romania, Turkey and FYR of Macedonia, as Eurostat statistics reveals. (However, there are no comparable data for the other SEE countries available, it is assumed that usage of Internet services is rather low in the whole region.) The number of individuals using online services is far behind the European figures, however certain indicator values (for example online

<sup>12</sup> NMS-10 refers to countries joined the EU in 2004

<sup>13</sup> There are no comparable data for the other countries.

telephoning, online broadcasting in Bulgaria and usage of eLearning services in Romania) converge to the EU average. Enterprise use of online services is in general at the same low level as households.

TABLE 5.

2006	BG	RO	TR	MK	NMS-10 <sup>14</sup>	EU27
Percentage of individuals having ordered/bought goods or services for private use	2	1	1	1	5	20
Percentage of individuals using e-government services	8	...	6	15	28	24
Percentage of individuals using Internet for seeking health information	4.9	5.1	3.1	3.1	14	20
Percentage of population using Internet banking	1.3	0.6	...	...	16	22
Percentage of enterprises' total turnover from e-commerce	0	1	...	...	4	12
Percentage of enterprises using e-government services	46	39	...	...	62	63

Source: Eurostat

### GOVERNMENT PRIORITIZATION OF ICT AND ICT POLICY DEVELOPMENTS

As all countries recognized the importance of ICT in economic growth, governments put efforts towards ICT developments. According to the World Bank<sup>15</sup>, governments of the SEE countries consider the IST usage and ICT sector production as important tools for catching up. Besides newly acceding countries and Turkey, Albania, Bosnia and Herzegovina, Croatia, FYR of Macedonia and Serbia and Montenegro formally joined European IT development process defined in the eEurope and eEurope+ Action plans and accepted an international agreement called eSEEurope Agenda for the development of the Information Society. Within the framework of this Agenda governments elaborated ICT/IST policies and strategies. On the one hand, implementation of strategies has slowed down in certain countries (Albania), on the other hand, other countries carried out important state level initiatives, programs and projects (Bosnia and Herzegovina, Croatia).

### CONCLUSIONS

All countries in the region are at a relatively early stage in information society developments. Because of the general low level of ICT infrastructure and IST usage more attention should be paid to reduce widening gaps between the more matured European economies and the Southeast European countries. Recognizing the importance of providing equal opportunity for participation in the information society is an essential step for all governments. Better ICT infrastructure in households, at enterprises and public institutions, better access and quality of Internet services, higher level of ICT skills are all requirements for a faster information society take-up, in which process Southeast European governments should take a leading role as well as should prefer ICT-led development strategies.

<sup>14</sup> NMS-10 averages refer to countries joined the EU in 2004. Averages are unweighted averages

<sup>15</sup> World Bank ICT at a Glance tables

<http://web.worldbank.org/WBSITE/EXTERNAL/DATASTATISTICS/0,,contentMDK:20459133~menuPK:1192714~pagePK:64133150~piPK:64133175~theSitePK:239419,00.html>

## CAN SERBIA REACH CANDIDATE STATUS OF THE EU IN 2008?

The EU resumed talks on a Stabilisation and Association Agreement (SAA) with Serbia on 13 June 2007, after the arrest of alleged war criminal Zdravko Tolimir on 31 May this year. However, the SAA talks, which represent a first step towards EU membership, will not be concluded unless Serbia fully co-operates with the International Criminal Tribunal for the former Yugoslavia (ICTY).

### DEVELOPMENT OF THE EU – SERBIA RELATIONS

Based on decisions of the Thessaloniki Summit in June 2003, Serbia is a potential candidate for EU membership. However, the country has already benefited from EU relations since 2001, when the EU-FRY Consultative Task Force (later Enhanced Permanent Dialogue) was established, being in charge of encouraging and monitoring reforms. According to the Feasibility Report of the Commission of 12 April 2005, Serbia and Montenegro was sufficiently prepared to negotiate the SAA. The SAA negotiations started originally with Serbia and Montenegro and were officially opened on 10 October 2005. Although substantial progress was made in the negotiation process (two official and two technical rounds were conducted), the country did not meet its commitments on co-operation with the ICTY. Thus, the Commission decided to recess the SAA negotiations on 3 May previous year. The condition for resuming negotiations was the full co-operation with ICTY, meaning the arrest of the most chased war criminals Radovan Karadzic (former Bosnian Serb leader) and Ratko Mladic (former military commander).

After the independency of Montenegro (June 2006) the Council has adopted amended negotiating directives for an SAA with Serbia, taking into account that Serbia became the successor state of the State Union of Serbia and Montenegro. After the end of the State Union the Enhanced Permanent Dialogue went on separately both with Serbia as well as with Montenegro. During the SAA negotiations were on hold, Serbia has continued to benefit from the Autonomous Trade Measures (ATMs) and receive substantial pre-accession financial assistance (EUR 167 million in the previous year) granted by the EU.

**TABLE 6. KEY EVENTS IN THE EU – SERBIA RELATIONS**

Event	
<b>1999</b>	The EU proposes the new Stabilisation and Association Process for five countries, including Serbia
<b>November 2000</b>	Framework Agreement FRY-EU for the provision of Assistance and Support by the EU to the FRY
<b>July 2001</b>	Start of the EU-FRY Consultative Task Force
<b>June 2003</b>	Thessaloniki Summit: Serbia becomes potential candidate
<b>July 2003</b>	Enhanced Permanent Dialogue replaced the format of the Consultative Task Force
<b>June 2004</b>	Council decision on the European Partnership for Serbia and Montenegro
<b>April 2005</b>	Feasibility Report of the Commission: Serbia and Montenegro is prepared for SAA negotiations
<b>October 2005</b>	Launching the negotiations for an SAA
<b>January 2006</b>	Updating of the European Partnership for Serbia and Montenegro
<b>3 May 2006</b>	Negotiations with Serbia and Montenegro called off
<b>June 2006</b>	Independency of Montenegro
<b>13 June 2007</b>	SAA negotiations with Serbia resumed

*Source: European Commission*

## REQUIREMENTS TO SIGN THE SAA

Serbia has made progress in ensuring macroeconomic stability, pursuing privatisation and attracting foreign direct investment. Economic integration with the EU has slowly advanced. The country has also registered success in administrative reforms. During the SAA negotiations, the Serbian administration turned out to have considerable institutional capacity, enabling Serbia to catch up with other countries of the region on the way to the EU. However, there are considerable challenges Serbia has to face.

Concerning political criteria, the most important obligation of the country is the full cooperation with the ICTY. Without putting under arrest war criminals, the EU is not willing to sign the SAA. Additionally, the new constitutional framework needs to be soundly developed and implemented in order to strengthen democracy and rule of law. Government activities have become more transparent since the formation of a new pro-reform coalition under Kostunica. Public administration, military and judicial reforms require further efforts in order to be in line with European legislation. The fight against corruption continued with adopting the National Strategy and the relevant Action Plan. As corruption remains a source of concern, a transparent institutional set-up needs to be established.

As regards economic criteria, stabilisation and reform efforts need to be continued in order to enable the Serbian economy to cope with competitive pressures within the EU. Thanks to the consensus on the direction of economic policy and reforms, economic growth continued in 2005. Recovering exports made the current account deficit narrow. Foreign currency reserves were boosted by strong capital inflows due to privatization and banks' foreign borrowing. Monetary policy was tightened and the cuts in expenditure and strong tax receipts contributed to the fiscal consolidation. However, inflation and external deficits remained relatively high. Additionally fiscal consolidation has stopped since the beginning of the previous year. Because of increased borrowing of the private sector, external debt rose. Due to lack of competition in domestic markets and slow progress in corporate restructuring, the enterprise sector remained generally weak. The level of Greenfield investment remained low, while unemployment has further increased.

## EXPECTATIONS

During foregoing negotiations, Serbia made good progress to approximate its legislation and policies with European Standards. Despite promising developments, there are still areas that need further efforts, not only to implement but also to fully benefit from the future Agreement. Areas such as taxation, state aid control, public procurement, intellectual property rights and consumer protection need strengthened administrative structures. The issues of food safety, environment, information society and financial control are also key elements of finishing SAA talks.

Besides political and economic requirements of signing the SAA, the most important condition for finishing negotiations, is the full cooperation with ICTY. According to Enlargement Commissioner Olli Rehn, in case the Serbian government cannot arrest the most chased war criminals, the EU will not sign the SAA. Thus, the date of signing the SAA and becoming an official candidate country for EU membership depends mainly on this criterion. It can be expected that after arresting war criminals, SAA talks will be finished as soon as possible, in order to prove Serbian citizens the EU is highly motivated and fully committed to the future membership of the country. In case war criminals are arrested until mid 2008, Serbia could become an official candidate country by the end of next year.



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