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Southeastern Europe: From upheaval to boom

1 Introduction

The economies of southeastern Europe are on the move. For some time now, real GDP in Bulgaria, Romania, Croatia, Bosnia, Montenegro, Serbia, Albania and Macedonia has been growing fast, with these countries' economies increasingly finding their feet in the global economy. What is more, Romania and Bulgaria have been members of the EU since the beginning of this year, promising them not only accelerated integration into the European single market but also considerable financial aid from Brussels as well as the establishment of stable institutions.

Still, **in comparison to the economies of Hungary and Poland, which joined the European Union in 2004, the southeastern European states are trailing behind**. The only exception is Croatia, which, in terms of its development and standard of living, has a clear lead on its neighbors. Various factors are responsible for the laggard status of southeastern Europe. Romania and Bulgaria have found it particularly tough transforming from a planned to a market economy due to the extent of collectivization that dominated these countries during the communist era. In Romania, for example, Ceausescu's regime did not allow any kind of entrepreneurialism. The states that emerged from the former Yugoslavia had it a little easier, relying on the market economy experience they had gained under a more tolerant socialist regime. However, the subsequent civil war was a severe political and economic setback for these countries. The conflict left Bosnia, in particular, in complete disarray, and Serbia is only just beginning to emerge from its shadow. Montenegro, for example, decided to separate from Serbia in 2006[*], and Kosovo is very likely to follow suit.

What does the future hold for Kosovo?

In light of Kosovo's long-drawn battle for independence from Serbia, the **proposal** put forward by **UN Special Envoy Ahtisaari** at the end of March may be the solution. Under the settlement plan, the province of Kosovo, which has been under UN administration since 1999, would be granted independent status and initially supervised by the EU. The designated EU representative would hold the highest civil authority and be granted extensive, including executive, rights to monitor compliance with the agreed independence status. The assignment of police officers, public prosecutors, judges and customs officers would support the establishment of an independent constitutional state welcoming all ethnic groups. NATO would remain responsible for ensuring the general safety and protection of the Serbian minority in Kosovo. Additional assistance would also be provided in the form of financial aid. **The proposal**, whose implementation requires a resolution by the UN Security Council, is **nonetheless controversial** as it would set a precedent in that the UN would decide over the independence of a former province of a state against its will. Ultimately, however, Serbia is likely to cooperate irrespective of whether Ahtisaaris' plan is put into action because the settlement of Kosovo's status is also an important prerequisite for intensifying Serbia's relations with Brussels and achieving the goal of EU accession.

The southeastern European states are not a homogenous economic group. There are considerable differences in economic structure, foreign trade integration and, above all, the

standard of living. They are also all small economies, with the exception of Romania. The small size of the states based on economic output and population has both advantages and disadvantages. On the one hand, it increases the efficiency of economic policy measures. On the other hand, the costs of maintaining the state system are of course high in relation to economic performance.

All of the states are now firmly anchored in democratic structures and are on the road toward political and economic convergence with the European Union. Croatia started EU accession talks in 2005, and Macedonia is likely to enter into negotiations next year. The remaining western Balkan states are still in the early stages of integration. While Albania and Montenegro have already signed EU association treaties, Bosnia and Serbia are still in the negotiation process. There is a lot to be said for the assumption that the EU could play a similarly beneficial role in southeastern Europe as it did in the eastern European states that joined in 2004; the support this time, however, being more in the establishment of stable economic institutions and frameworks rather than financial aid. As in the rest of eastern Europe, the southeastern European states are well known for their swing voters. In these circumstances, a party that has not been very successful during its term in office can thank its lucky stars if it retains any representatives in parliament at the next elections. In a situation such as this, stable institutions can help the economy stave off uncertainty arising from frequently changing governments.

2 Where do the southeastern European states stand today?

2.1 Economic development

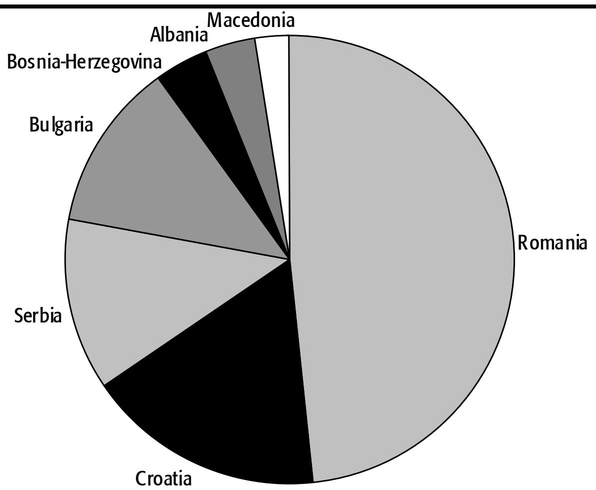
Following the political changes of the last few years, southeastern Europe has developed into a **fast-growing emerging market**. Since 2000, real GDP in this region has risen by an average of at least 5 %, thereby slightly outperforming the economies of the new EU member states from central and eastern Europe. **This highly dynamic trend, however, contrasts strongly with the comparatively low level of economic strength and immense gaps in per capita income within this group of countries.** Overall, GDP for the region is not even on a par with Poland. Within the Balkan region, Romania is by far the largest economy, generating almost half of the region's GDP, followed by Croatia (17 %) and Bulgaria and Serbia (both 12 %). In terms of overall population, Romania is again at the top, with just under 22 million inhabitants. Comprising 7 to 8 million people, the populations of Bulgaria and Serbia are almost twice the size of Bosnia-Herzegovina and the economically stronger state of Croatia. By contrast, the population of Macedonia is hardly any larger than in many western European cities.

The heterogeneity of this group of countries is reflected in particular in per capita income. Croatia is at the top of the league, with its per capita income of around EUR 7,600 lying slightly below the average for the eastern European EU states. Romania's per capita income is only 60 % of that of Croatia. The standard of living in Serbia and Bulgaria is only slightly lower than that, followed by Macedonia and Albania, with Bosnia's per capita GDP of EUR 2,000 bringing up the rear. Whether due to differences in economic

[*] Montenegro will not be analyzed separately below, since the data situation remains difficult.

cycles and/or demographic trends, these gaps between the Balkan states have tended to widen since 2000. While the populations of Romania and Bulgaria are following the ongoing declining trend of many eastern European countries, Albania's and Bosnia's are growing by an average 0.5 % p.a. There are also differences in the **economic structure** of the Balkan states. The lion's share of GDP – well over 60 % - is generated by the services industry. Due to the significance of its tourism sector, Croatia is a prominent example in this respect (over 70 %), whereas in Bulgaria and Romania industry contributes around 25 % to GDP. In Albania and Serbia, however, the agricultural sector plays a comparatively large role, contributing almost 17 % to GDP.

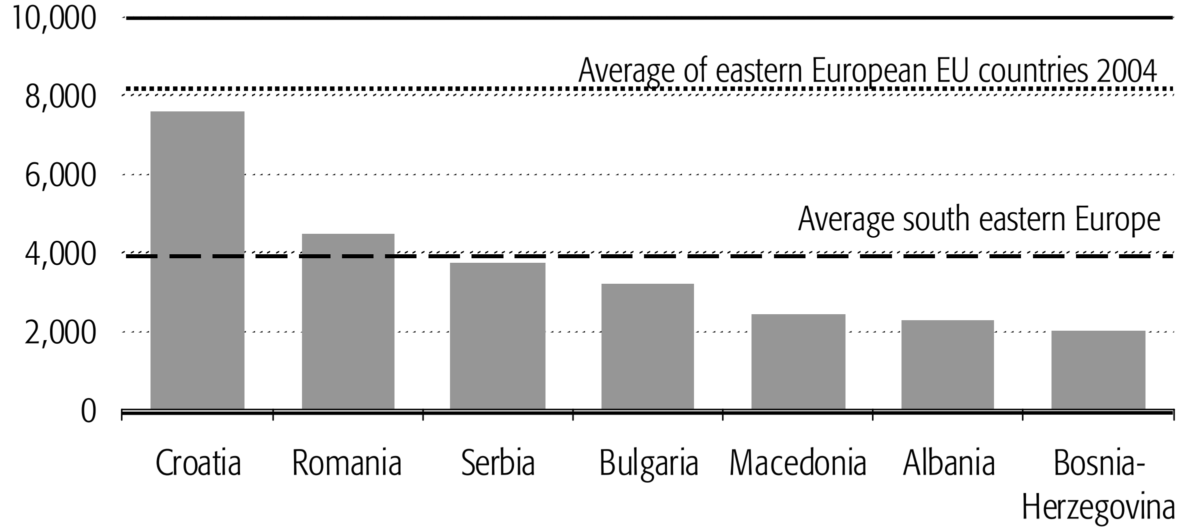
Economic strength in comparison
GDP shares in % (2006)



Total GDP of southeastern Europe: USD 252bn
compared to eastern European EU countries 2004: USD 750bn

Source: IMF, own calculations.

The gap in living standards
GDP per capita in EUR (2006)



Source: IMF, own calculations.

Although the region overall tends to be lagging behind, a lot has been achieved in terms of **macroeconomic stability**. According to recent economic data, inflation rates in all but one Balkan state, namely Serbia, are under 10 %. Owing to monetary and fiscal stability policies, the budget deficits of these countries have also shrunk, now seldom exceeding 3 % of GDP; Romania, Bulgaria and Bosnia are even recording budget surpluses. **The huge current account deficits are the Achilles' heel of the region,** yet given the high demand for real capital to overhaul the economy and the pent-up level of consumption, this is no surprise. The largest deficit – well over 20 % of GDP – is hanging over Bosnia. Bulgaria, Romania and Serbia also have deficits of 10 % or more. Macedonia is the only country that has managed to generate a small surplus. The shortfalls are now at least being partly financed by the increasing amount of foreign direct investment in the region. Loans granted by official creditors are also playing a significant role in the less developed countries of Albania, Bosnia, Macedonia and Serbia. Thanks to flourishing exports, foreign debt in relation to exports has fallen considerably in most countries over the last few years and now lies at an acceptable level of around 100 %. The only concerns are the high percentage of short-term debt in Croatia and the high foreign debt ratio of 250 % in Serbia.

Data table for southeastern Europe

		Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Romania	Serbia
GDP in EUR bn	2006	7.2	7.9	24.3	33.7	5.0	96.7	25.1
Population in millions	2006	3.2	4.0	7.7	4.4	2.0	21.6	7.5
GDP per capita in EUR	2006	2,301	2,010	3,170	7,586	2,428	4,471	3,349
Real GDP growth in %	2006	5.0	6.0	6.2	4.6	4.0	7.7	5.4
Inflation rate in % (year average)	2006	2.2	6.0	7.3	3.2	3.2	6.6	12.7
Current account balance as % of GDP	2006	-5.9	-23.3	-15.9	-8.1	0.4	-10.3	-12.3
Stock of foreign direct investment per capita in EUR	2005	536	527	1,479	2,596	923	1,095	727
Foreign debt as % of exports	2005	94.5	95.6	112	159.8	93.1	98.2	246.9
Sources: IMF, EBRD.								

In order to inspire confidence in their respective currencies, Bulgaria and Bosnia established currency board systems in 1997, centered on free convertibility and a fixed euro exchange rate. Following its independence in 2006, Montenegro even went a step further by introducing the euro as the sole legal tender. Croatia, Macedonia and Albania have also kept their euro exchange rates constant by operating a managed float regime. Given their small size and prevalent euroization often stemming from periods of crisis, the choice of a quasi-fixed exchange-rate system was the way forward for these countries. Romania and Serbia allow their currencies to fluctuate more freely in order to use the exchange rate as a buffer for the structural adjustments they still have to make to their economies.

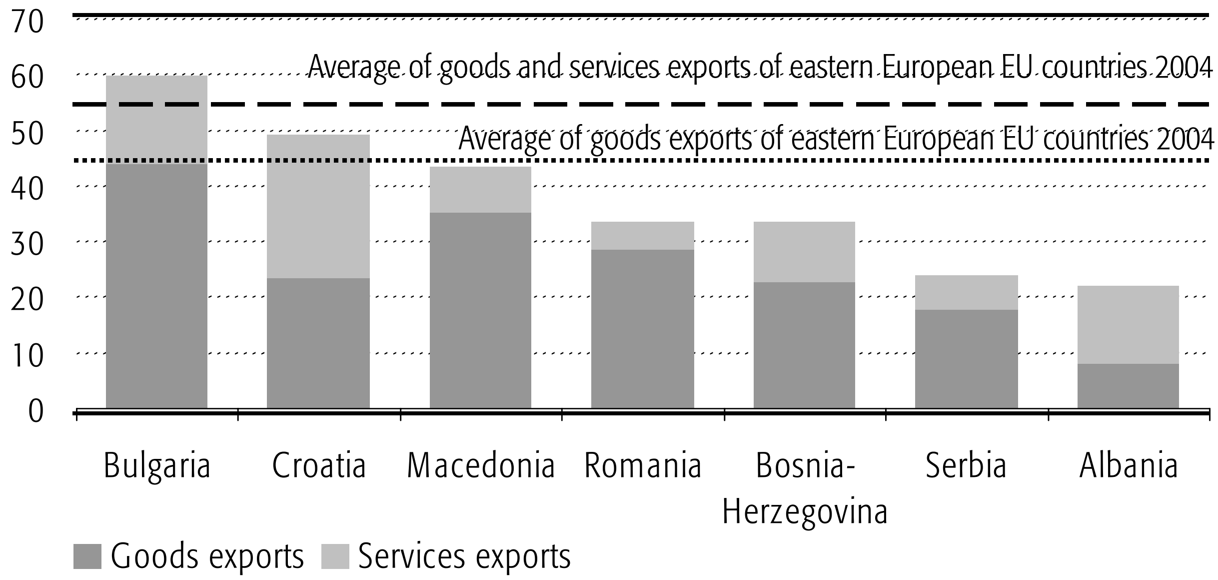
2.2 Prospects for foreign trade

With the exception of Romania, the southeastern European states are small economies. Countries such as these are generally very open to foreign trade, which is reflected in a high level of exports. **Compared with the eastern European EU countries, however, southeastern Europe (still) has a low level of foreign trade.** This is particularly the case for purely goods exports, whereas the export of services in southeastern Europe does better than in the new EU member states due to the greater significance of tourism in the region.

The top goods exporter is Bulgaria, which exports around 44 % of its GDP. Second is Macedonia (35 %) and then Romania (29 %). Croatia, Bosnia and Serbia are next, only achieving goods exports of around 20 % of GDP. At 8 %, Albania is still largely isolated from the global market. On a US dollar basis, exports are showing momentum, growing annually by around 20 %, more or less in line with the new EU states. Since the beginning of the reform phase, the regional structure of foreign trade has also changed in that **the Balkan countries have successfully shifted their import/export focus to the EU.** This, however, has by no means reached the same proportions as in the first accession wave. With the exception of Romania and Croatia, whose integration is further advanced, and Albania, which trades almost exclusively with its EU neighbors Italy and Greece, “only” 45 % to 55 % of exports from the southeastern European states are destined for the EU. Interstate trade within the region, in particular, continues to play an important role, accounting for up to two fifths of exports in some countries. Contributing factors have been the free trade agreements between the former Yugoslavian countries and also Turkey’s booming economy over the past few years. **The range of exports produced by the majority of the Balkan states is still small and is characterized by a low level of manufacturing depth.** Overall, the southeastern European countries, as the second EU accession group, seem to be finding it harder to gain a foothold for their products in western Europe, the reason being that their location advantages, such as low wages for well-trained workers, have initially been overshadowed by the eastern European EU countries. As the Balkan region continues to develop, however, so too will its opportunities of attracting foreign investors and increasing export demand, as can be seen in the rising level of direct investment. In the textile and clothing industry, the Balkan states are admittedly in competition with the Asian emerging markets, whose production costs are sometimes even lower, yet for many western European investors and importers, geographical proximity plays an important role.

A further source of income for a number of the Balkan states is tourism. This is the case for Croatia and Bulgaria, but also surprisingly for Bosnia and Albania. While Croatia generates at least 25 % of its GDP from the tourism sector, and Bulgaria 16 %, this ratio is still an impressive 12 % in the two small countries. The figure is attributable to the large number of Bosnians and Albanians living abroad. Not only for those countries, but also for southeastern Europe as a whole, these “guest workers”, living mainly in the EU, play an important role by transferring money back home, thereby financing a considerable portion of their home countries’ hefty foreign trade deficits and increasing the standard of living in the region.

Level of openness in foreign trade
Exports as % of GDP (2005)

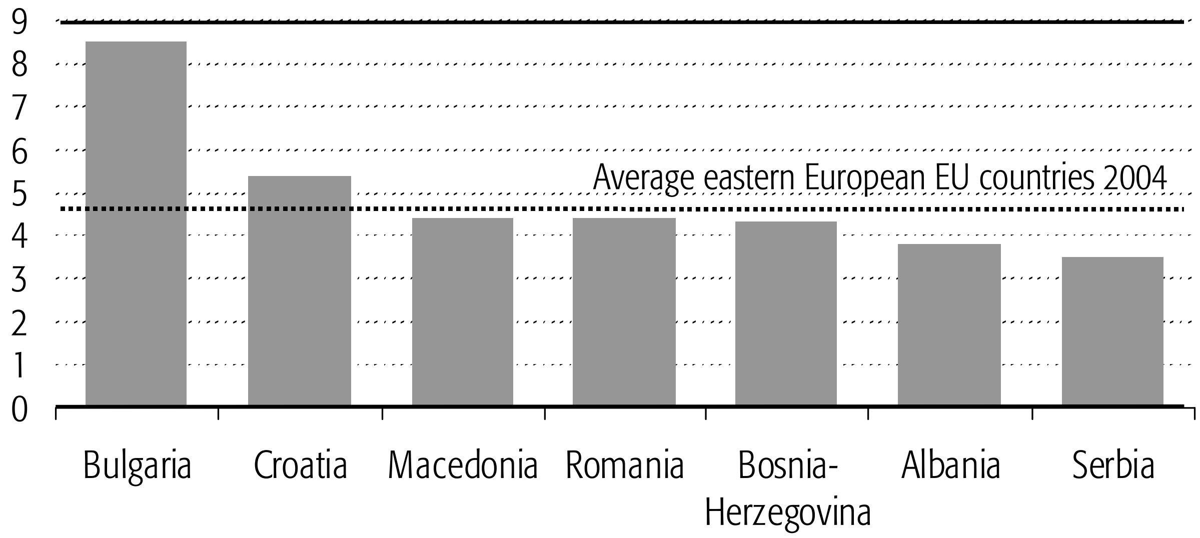


Source: IMF, own calculations.

2.3 Capital ties as integration driver

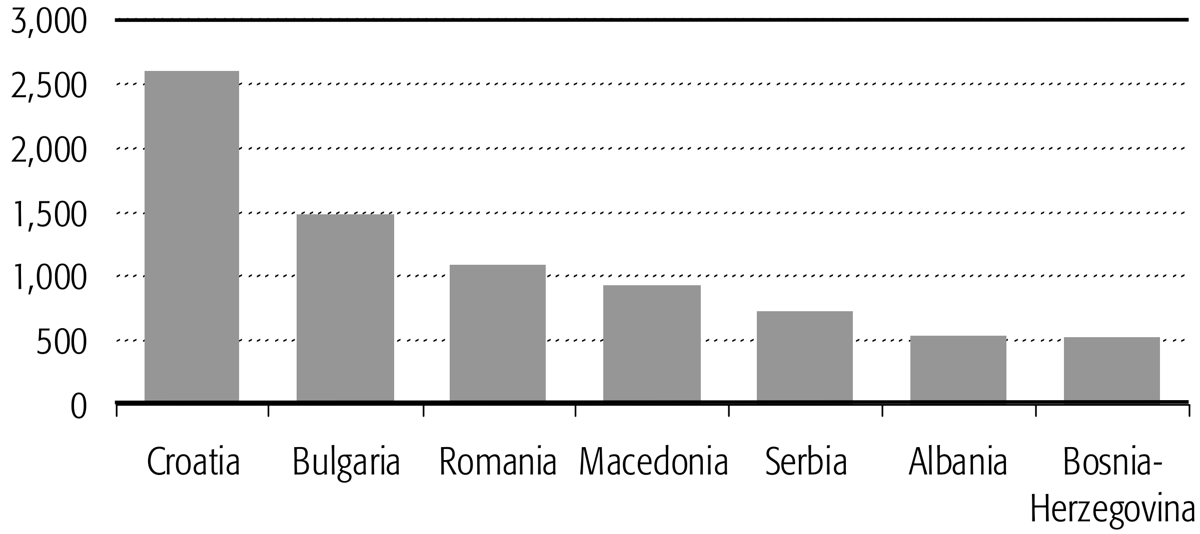
Foreign direct investment is crucial for the structural change so urgently needed in the transformation countries. Why? Because foreign investment capital makes a significant contribution toward modernizing and building up what is often outdated capital stock and thereby gives rise to new growth potential. Companies not only receive the necessary capital from this inflow of direct investment, but also expertise and new distribution channels. **In relation to the size of their economies, southeastern European states now attract more direct investment than the eastern European EU countries.** However, there is **considerable divergence between these states**. Bulgaria and Croatia, for example, stand out from the rest, attracting an average 8.5 % and 5.5 % of GDP p.a., respectively, in the period from 2000 to 2005, compared with an inflow of around 4 % for the remaining Balkan countries. Romania and Serbia, however, have been able to catch up recently, recording an inflow of 6 % of GDP. Due to the later entry into the transformation phase, the per capita volume of investment in southeastern Europe is of course significantly below that of the eastern European EU states, Croatia being the only country that is currently on their heels. All the same, the per capita volume of investment recorded by the laggards Albania, Bosnia and Serbia has now reached levels that were recorded by a number of the now acceded eastern European EU countries at the end of the nineties. The potential has therefore been signposted, even if speculation about the Balkan states joining the EU so far remains off the boil.

Inflow of foreign direct investment as % of GDP (average 2000 to 2005)



Source: IMF, own calculations.

Stock of foreign direct investment per capita (USD, 2005)



compared to eastern European EU countries 2004: USD 3,555

Source: IMF, own calculations.

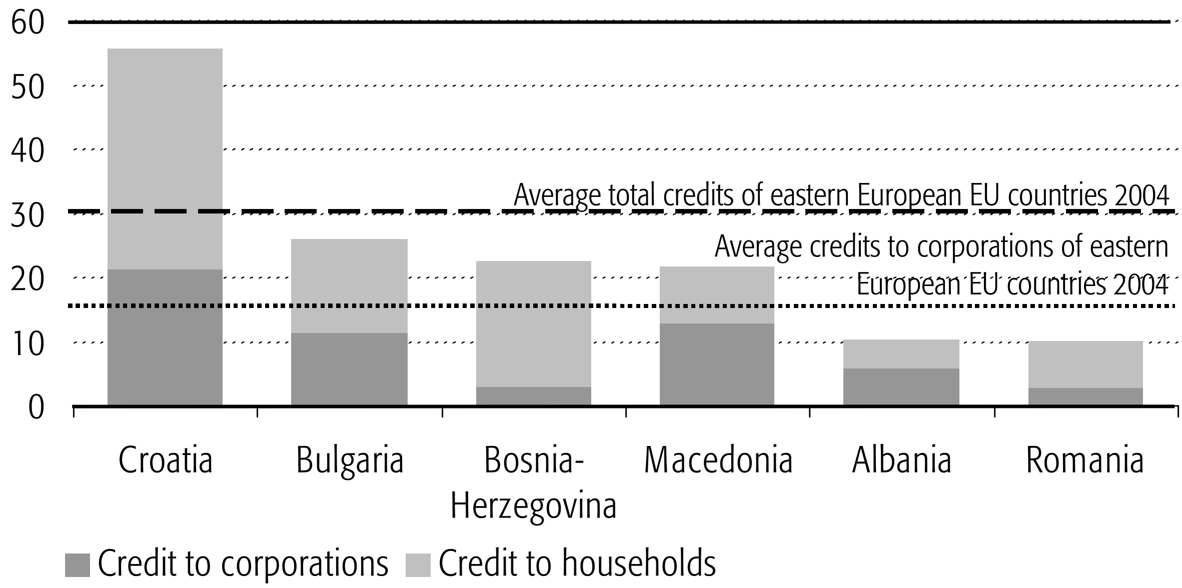
EU investors are the most important capital providers in southeastern Europe. The average share contributed by the EU25 to the total volume of foreign direct investment was around 80 % in 2005, as opposed to some 70 % by the former EU15. EU integration is therefore far more advanced in terms of capital provision than it is for foreign trade. This shows **that the objective of western European investors is not only to exploit cost advantages for exports, but also to tap domestic markets**. Through privatization and/or consistent efforts to open up the financial sector, at least half of the foreign direct investment made in Bulgaria, Croatia and Serbia have been channeled into the services industry, e.g. banking, postal services and telecommunications. These investments will serve to improve the local infrastructure and thereby indirectly increase the productivity of the countries, but they will not directly contribute toward restructuring the manufacturing sector. By contrast, investors in Romania, Bosnia and Macedonia have tended to focus more on the manufacturing industry, which accounts for some 40 % of the total volume of direct investment. Marked productivity gains and greater export opportunities can be expected from these investments, while the services industry takes a back seat.

2.4 The role of banks

The economic upturn of the past few years is not least due to improved financial intermediation in the Balkan states. **Between 2000 and 2005, for example, the ratio of domestic loans to GDP increased by at least 100 % in almost all of the states**. At the root of this development was the **restructuring and consolidation of the banking sector**, in which the previously state-owned banks were privatized and foreign banks permitted. The investments made by foreign institutions, in particular, by acquiring either local banks or else licenses to set up their own subsidiaries, have catapulted the southeastern European banking markets into a new age in terms of technology, know-how and competition. As a result, the variety of instruments has increased significantly in the lending and deposit business, the percentage of non-performing loans in banks' portfolios in most of the countries is less than 5 % of outstanding loans, and the capital resources of the banks are largely in line with international standards.

However, there are also differences between the states in this regard. The banking market in Croatia is the most developed, showing a loan penetration rate of 55 % of GDP, which is comparable with that of Hungary or Slovenia. As is the case with Albania and Bosnia, the Croatian banking sector is almost exclusively in foreign hands. With a loans/GDP ratio of 26 %, Bulgaria ranks second in the region, albeit with three thirds of the aggregated balance sheet total being generated by foreign banks. In Romania, financial intermediation via banks is still in the early stages, its loans/GDP ratio amounting to a mere 10 %. This is most likely due to the below-average presence (60 %) of foreign banks, and is reflected in a higher percentage of non-performing loans. Serbia and Macedonia have the weakest banking systems with a BIS capital ratio of 8 % (the required minimum) as opposed to 12 % in the other states.

Credit stock as % of GDP (2005)



Sources: EBRD, IMF, own calculations.

Due to the increasing level of macroeconomic stability, loans in local currency as well as loan maturities are also likely to increase in the region. This, however, will hinge on whether insolvency law and creditor protection can be enforced. The fact that this is not yet the case across the whole region is reflected, for example, in the loan boom experienced in Bosnia and Romania, which benefited many private households but hardly any companies – as would be expected in countries with an investment backlog. This has placed small and medium-sized companies, in particular, in a financial quandary as they have hardly any possibilities to access the international banking and capital market and the **domestic financial markets remain underdeveloped**. The large states of Romania and Bulgaria, for example, have equity market capitalization rates of 20 % of GDP, a long chalk from the 30 % or so recorded by the more advanced eastern European economies of Poland, Hungary or the Czech Republic. Croatia is the only country with a market capitalization rate on a par with these eastern European neighbors. The market, however, is largely illiquid.

2.5 The EU as stabilizer

The **prospects of EU accession and the association agreements already concluded have boosted the reform process in all of the Balkan states.** Besides greater security in foreign policy and increasing efforts to anchor democratic structures through closer integration with the EU, substantial financial aid from Brussels is also at the top of the political wish list in this region. **However, establishing stable institutions and bringing these countries in line with EU norms is no walk in the park.** Even in Bulgaria and Romania, which joined the EU in January, the legal system still has a long way to go before it reaches EU standards. The European Union has also threatened to impose sanctions after accession if, for example, the laws to combat corruption and money laundering are not enforced.

The financial aid provided by the EU is playing a significant role in improving the economic and legal framework of these countries. Romania and Bulgaria have so far received funds from the Phare (state institutions) and SAPARD (agricultural) programs. Since joining the EU at the beginning of the year, both countries have had access to the EU agricultural and cohesion funds. This year alone, they have probably received a total of EUR 4 to 5bn in financial aid, which corresponds to an inflow of around 3.5 % of their respective GDP. The requirement that a certain number of projects be locally co-financed, however, will mean that not all of the funds will be called upon, which is no tragedy if the region wants to ensure that it uses the financial aid efficiently. Since 2005, Croatia has also had access to EU pre-accession funds, but these account for less than 0.5 % of GDP. For the period from 2000 to 2006, the CARDS (Community Assistance for Reconstruction, Development and Stabilization) program was developed for the western Balkan states, granting EUR 4.6bn in aid. Serbia and Montenegro together received EU aid of around 1.3 % of GDP, Macedonia just under 1 %, Bosnia and Herzegovina 0.7 % and Albania 0.5 %. From 2007, all financial aid for potential accession candidates will be pooled in one instrument – the IPA (Instrument for Pre-Accession Assistance).

Southeastern Europe: Where do the countries stand?

	Albania	Bosnia and Herzegovina	Bulgaria	Croatia	Macedonia	Romania	Serbia
Macro-economic stabilisation	++	+	++	+++	+++	++	+
Domestic market	+	+	++	+++	+	+++	++
Export strength	+	++	+++	++	++	+++	++
Banking system	++	++	++	+++	+	++	+
EU integration	++	++	EU member	+++	++	EU member	+
+++ = good; ++ = satisfactory; + = insufficient							

3 The next ten years

Following in the footsteps of Romania and Bulgaria, **Croatia** looks likely to be the next Balkan state to join the EU. By the end of the first year of accession negotiations, which were initiated in October 2005, significant progress had already been made. The implementation of the stabilization and association agreements went without a hitch and the chapter regarding “science and research” was provisionally concluded. We therefore see **accession in 2010** as realistic. Although Macedonia has also had candidate status since December 2005, accession talks have yet to commence. That aside, however, entry into the European Union will be more difficult for Macedonia and the remaining Balkan states than it was for those states that are already members. Firstly, the shadows cast by Turkey’s accession request and the resulting general EU debate about future enlargement rounds. Secondly, the political problems in Serbia (faltering cooperation with the War Tribunal at The Hague, nebulous situation in Kosovo), which continue to put the brakes on the integration process. And thirdly, the economic disorder in Bosnia and Albania, which is likely to hinder their early accession – i.e. within the next ten years.

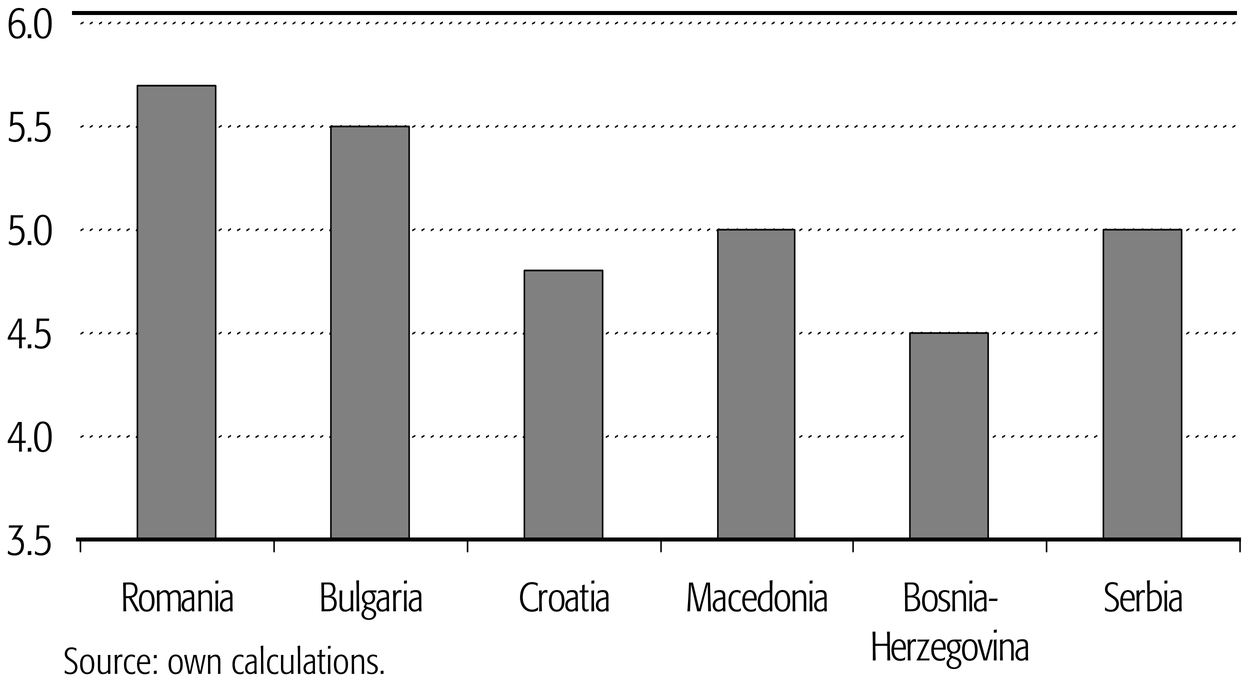
For all of the states in this report, **European economic and monetary union is an even more distant prospect.** Entry will only be conceivable if the states make considerable improvements to their economic structure and of course fulfill the Maastricht criteria. This is also the case for Bulgaria, which, due to its exchange rate system, would have the least difficulties joining EMS II. Even in the larger states that joined the EU in 2004, the euphoria surrounding an early introduction of the single European currency has since given way to a more realistic view of the situation.

Romania and Bulgaria **had already geared up economic growth** during the negotiation phase, i.e. **before they actually joined the EU**. This was in the footsteps of the central and eastern European countries welcomed into the EU in 2004, which also recorded the largest increase in economic momentum prior to accession. The reason for this phenomenon, which is only surprising at first glance, is that the "Community *acquis*" (including the establishment of stable institutions), which has to be largely in place before accession, had already been implemented to a large extent by the time these countries joined the EU. Transfer payments had also already been paid out at an early stage as part of pre-accession assistance. Last but not least, the private sector also preempted the positive effects of EU membership, showing an increase in foreign direct investment. Since the official start of accession talks in 2000, real GDP in Romania has increased by an average 5.5 %, contrasting with an average decrease of 2.3 % in the preceding decade. In 2007, Bulgaria and Romania are to receive structural aid amounting to 2.4 % of their GDP. This will increase to 3.2 % in 2008 and then amount to 4 % every year until 2013. The next ten years will also see a continuously increasing flow of agricultural aid, meaning that the transfer payments from the EU to these countries will probably amount to around 7 % of GDP in the final phase.

This flow of funds will keep the pistons driving the economies of these two countries well oiled. Infrastructure will be the main beneficiary of this financial aid, with the resulting improvements to the export channels of Bulgaria and Romania, in particular, likely to provide a real boost to the countries' export industries. **For the next five years, we therefore continue to forecast average growth rates of between 5 % and 6 %.** After that, the economies should trundle back to a more moderate growth path. Croatia, too, was able to significantly increase its real GDP growth rate before entering into negotiations with the EU in 2005. Given the considerable lead Croatia already has over its neighbors in terms of economic development, the country will enjoy growth rates of **between 4 % and 5 %, slightly less than Romania or Bulgaria.**

Macedonia will benefit from its candidate status and achieve average economic growth of around 5 %. The Serbian economy, too, looks set to grow by an average 5 %, even without any imminent prospects of joining the EU. Serbia's advantage is that it is relatively large, making it an attractive export market. It also boasts a well-trained labor force and stable institutions such as the professionally managed central bank. Although the remaining Balkan states are likely to benefit from the sound growth expected in Romania, Bulgaria, Croatia, Serbia and Macedonia due to their economic relations, overall, they will be left behind by this dynamic quintet.

Average real GDP growth in % (2006 to 2016)



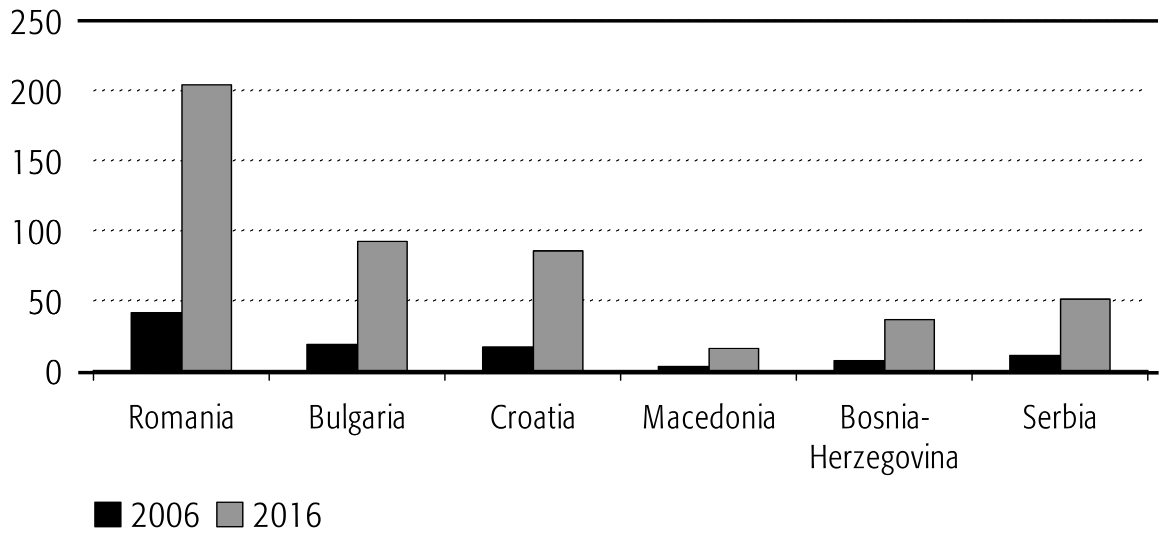
Source: own calculations.

A decisive factor for maintaining the high levels of growth will be the foreign direct investment (FDI) in the region, which, despite the ebbing wave of privatizations, at least in the large states, will continue to flow in the coming years. This ongoing flow of equity capital contrasts with the trend seen in the states that joined the EU earlier, namely that the main flow of FDI occurred prior to accession. By far the most funds are flowing into Romania, yet Bulgaria, Serbia and Croatia also attracted investments into the billions in 2005. With the exception of Croatia, wage costs, for what is a relatively well-trained workforce, are so low – even compared with other eastern European EU countries – that **Romania and Bulgaria** could well become **an attractive option for companies with more labor-intensive production lines that are looking for locations within the EU**. Even if the legal system is nowhere near on a par with the EU, it can certainly offer a great deal more security than the low-wage countries of Asia, especially regarding the protection of intellectual property. The geographical proximity is also a bonus. The distances between producers and customers, particularly in the euro area, are much smaller, which is of particular advantage to markets where products change frequently and fast. However things develop, the attractive production conditions offered by both countries will definitely make them strong competitors for the 2004 accession countries. The “old” EU15, however, with their high-tech industries, should have fewer problems with these new rivals. They may in fact even be able to benefit from even cheaper suppliers from Romania and Bulgaria.

Germany has also made considerable investments in the Balkan states. Croatia, Romania, and, to a much lesser degree, Bulgaria, have been in the German investor spotlight for some time. In the case of Croatia, investments aimed at tapping the domestic market are likely to play the most prominent role. Added to this are real estate investments by Croatian citizens living in Germany. As a production location for non-EU markets, however, the country is hardly of any significance. As the wave of German companies establishing themselves in Croatia is slowly coming to an end and real estate acquisitions have probably reached their peak, we anticipate that **German direct investment will continue to shift focus to Romania and Bulgaria** over the next few years**,** where the German economy is lagging behind its EU counterparts. Dutch and Austrian companies, for example, are already much more active on the Romanian market, and Austrian and Greek companies, in particular, on the Bulgarian market. Macedonia also attracts direct investment, especially in the manufacturing sector, but the country is too small to play a more dominant role. Serbia is also likely to drop behind the Bulgarian, Romanian and Croatian trio, despite Germany being the main investor in the country. Opportunities are rife in all of the countries, and not only in the manufacturing sector, but also, and more importantly, in the services sector, which remains underdeveloped.

In addition to the capital ties between the Balkan states and Germany and the remaining EU states, foreign trade also looks set to increase again considerably over the next few years. Romania, Bulgaria and Croatia, in particular, are turning into attractive export markets for the German economy due to the marked increase in domestic demand. The increasing investment activities of both local and international companies are likely to be of particular benefit to German mechanical engineering exports as well as the business services sector. The swift rise in the standard of living has also made these countries attractive to other industries. Over the next ten years, Romania's demand for imports will rise to over EUR 200bn, Bulgaria's to around EUR 90bn and Croatia's to over EUR 80bn. That means that we can expect the **imports of these countries to grow by an average of just under 20 %**. German exports to Romania are likely to rise to EUR 28bn, and exports to Bulgaria and Croatia to EUR 14bn and EUR 12bn, respectively. In the medium term, the investments made by German companies in the manufacturing sector in Romania and Bulgaria will also boost demand for German imports from these countries. The German trade surplus attributable to these countries is therefore initially expected to continue growing, but then drop from 2012 onward.

Import demand in EUR bn (2006 against 2016)



Source: IMF, own calculations.

In the coming decade, the **standard of living** (based on per capita GDP at prices and exchange rates recorded in 2006) is likely to **almost double in the Balkan states**. While the population is forecast to fall slightly, the region's economies will pick up pace. In 2016, however, Croatia will be the only country to have reached a standard of living almost double that of the average enjoyed now by the eastern European states that joined the EU in 2004. In ten years' time, Romania, Bulgaria and Serbia will probably have reached a level similar to that recorded in those EU member states now, whereas Macedonia and Bosnia will have only just reached the level enjoyed at present by Romania and Bulgaria.

These projections are of course based on assumptions. For example, we assume that the political decisionmakers in these states will not succumb to their old habits and instead continue to take a more open approach and promote democracy across the board. Another key assumption is that no massive political and economic shocks emanating from outside this region will affect the states during the forecast period. A final assumption is that the economic situation in the EU will remain satisfactory. This does not exclude the possibility of temporary setbacks and varying growth patterns within the EU, but the general economic climate for southeastern Europe is nonetheless expected to remain stable.

Southeastern Europe often sails in the slipstream of the central European states that have already joined the EU. But this does not have to be a disadvantage. The small size of these economies, in particular, can have a positive effect on economic performance. This is because of the greater economic transparency and often more flexible economic policies of these countries compared to their larger counterparts. **All in all, we believe that southeastern Europe is on the right track to enjoying a brighter economic future.** This forecast carries even more weight if we consider the political and economic turmoil that afflicted this region in the not too distant past.