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**ROMANIA AND BULGARIA – TWO NEW EU MEMBERS**

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## Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

LUT has a long tradition in conducting research and educating students in the field of communist and post-communist economies. From the point of view of these studies, LUT is ideally located in the Eastern part of Finland near the border between EU and Russia.

This short report deals with one of the most important aspects of post-communist Europe, the Eastern enlargement of the EU. This book provides an overview of Romania and Bulgaria which joined the European Union in 2007. These two EU-newcomers have a rather modest living standard in pan-European comparison. Thus, they can offer conveniently low costs especially in labour-intensive activities, which is likely to attract foreign direct investment from the West.

Lappeenranta, June 2007

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## 1 Introduction

In the Cold War period, Europe was divided in two parts by an ideological borderline called “The Iron Curtain”. Behind that curtain were communist states with their centrally planned economies and their own trading bloc called Comecon or CMEA (Council of Mutual Economic Assistance). After the collapse of European communism (1989–1991), this Eastern integration scheme ceased to exist. In the 1990s, pan-European economic integration started to take shape.

The 1st of May, 2004, is an important milestone in this integration process: the Eastern enlargement of the EU took place. In this context, EU got ten new members, eight of which are post-communist countries called commonly transitional economies (TEs). These TEs with EU-membership are called new member states (NMSs). Two TEs were relegated in the 2004 enlargement of EU: Romania and Bulgaria. These two candidates were told to improve their economic competitiveness before receiving the EU membership (for details, see T. Tiusanen: *Transitional Economies and International Competitiveness*. NORDI publication No. 31, Lappeenranta, 2006). Romania and Bulgaria became EU-members with a delay, January 1<sup>st</sup>, 2007. Thus, there are ten NMSs presently.



## 2 Some Background Factors

Romania and Bulgaria are neighbouring countries on the Western shore of the Black Sea. In the former, the population in 2005 was 21,6 million and the latter 7,7 million. In both countries population has been in decline in the post-communist period.

Both countries under review were for centuries in the Ottoman Empire, but became independent kingdoms in 1878. In the 1940s, Bulgaria and Romania became parts of the Eastern Bloc, as the Soviet dominated part of Europe was called in the post-war period.

In the pre-communist era, Romania and Bulgaria were agrarian societies, which experienced in the post-war period a forced industrialization beyond the capacities of their communist rulers.

A rapid urbanization of the society took place in the first two decades of the communist era in both countries under review. The early five-year plans underlined the growth of heavy industry based on raw material imports from the Soviet Union.

In the 1960s, economic trends in Romania and Bulgaria started to take different shapes. Romania's communist dictator, Nicolae Ceausescu, turned away from integration with other communist countries, especially the Soviet Union. In turning to the West, he gained access to international credits, and thus, to Western investment goods. However, the communist economic environment was unable to use imported machines optimally. It became necessary to reschedule the country's foreign debts in the early 1980s.

In this context, the communist government imposed on the country a severe regime of foreign trade: exports were maximized and imports minimized on the expense of local consumption. Ceausescu's local popularity vanished and his political image in the West decreased. In the late 1980s, Romania's economy was in real chaos.

In Bulgaria, the long-serving communist leader, Todor Zhivkov, took a different path in the economy. No other communist country was as tightly integrated in the Eastern Bloc, as Zhivkov's Bulgaria, which was an extremely important supplier of the industrial-military complex of the Soviet Union. About 80% of Bulgaria's foreign trade was with other communist countries, the highest figure in Eastern Bloc in the 1980.

It is actually surprising that Bulgaria became credit unworthy in the last years of the communist rule. Even if the country had very thin trade relations in the West, it managed to receive extensive international credits it was unable to service.

It is not the aim here to describe differences and similarities in Bulgarian and Romanian economic developments of the communist era in detail. It suffices to state here that these two countries in the South-Eastern corner of Europe had both very difficult early period of transition. That is one the most decisive reasons why Bulgaria and Romania have had problems in joining the EU.

In this context, it is worth noticing that three NMSs are former Soviet republics (Estonia, Latvia and Lithuania). These three countries thus had no nationhood in the communist era. These countries had to start their transition by creating national institutions. Bulgaria and Romania were not confronted with this difficulty in the early 1990s. As satellites of the Soviet Union, all Eastern Bloc countries had their own planning office, central bank, etc. on the individual country basis. Estonia, Latvia and Lithuania were in the economic sphere run directly by Moscow during the communist era.

As Bulgaria and Romania were accepted to EU, it is appropriate to take up some statistical points linked with historical development of these two national economies. In the pre-war period, these EU newcomers were agrarian societies more or less on the same development stage with Greece and Portugal. The former joined EU in 1981 and the latter in 1986.

**Table 1. Per capita income, 1938 and 1990**

Country	Per Capita GNP in 1990, USD		Date Manufacturing Employment Exceeded Agricultural Employment
	1938*	1990	
Austria	1.800	19.200	1950
Czechoslovakia	1.800	3.100	1940
Finland	1.800	26.100	1950
Italy	1.300	16.800	1960
Hungary	1.100	2.800	1970
Poland	1.000	1.700	1970
Portugal	800	4.900	1980
Spain	900	10.900	1970
Bulgaria	700	2.200	1970
Greece	800	6.000	1990
Romania	700	1.600	1980

\* The figures for 1938 have been adjusted to 1990 prices with the U.S. GDP deflator

Source: Pohl & Sorsa (1992); OECD, Historical Statistics; World Bank, Development Reports, various annual editions.

Former Czechoslovakia was the only industrial country which became communist in the aftermath of the Second World War. In per capita income it was approximately on the same level with Austria and Finland. In the former living standard was over ten times higher in 1990 than in 1938, while the latter was able to increase its welfare by factor 15 in the same time frame. The equivalent multiplier in Czechoslovakia was less than two. These figures show clearly how superior market system is in comparison to central planning in welfare creation.

Greece had 7,5 times higher per capita income in 1990 in comparison to 1938. The equivalent figure in Portugal is somewhat lower, about factor 6. Bulgaria and Romania became urban-industrial societies in the communist era. The former was able to increase its living standard more than threefold in the time frame given in the above table, while the latter in the same period of time managed to roughly double its development stage. These figures reflect absolute achievement, but in relative terms results are dismal in comparison to Greece and Portugal. In Southern part of Europe Italy and Spain have achieved living-standard improvements which are far superior to Romanian and Bulgarian welfare gains. The above table shows really striking differentials in per capita income figures over a period of about half a century.

### **3 Economic Trends in Transition**

#### **3.1 Economic Growth**

In all communist economies, the inefficiency of a system in which producers faced neither competition nor market-clearing price was extremely costly. It helped prove the centrally planned system unsustainable. Moreover, the planners found that their ability to develop and implement sound plans was increasingly limited by the complexity of information they required and by the inability of their economy to deliver the material abundance the communist ideology promised.

The communist industrialization in Eastern Bloc was based on increasing foreign trade within the communist group (CMEA). The Soviet Union with its enormous natural riches provided raw materials in exchange for manufactured goods from its satellites. As new industries were quickly built up in the Bloc in the 1950s and 1960s, economic growth was rapid. However, in the 1970, and especially in the 1980s, this wasteful system faced bottlenecks in production of non-renewable natural resources in the Soviet Union. Trade within the CMEA started stagnating or even decrease. Diverting trade to the West proved difficult because the Eastern Bloc countries were unable to improve their competitive position in qualitative terms, and thus, was forced to offer low value-added, resource-intensive exportables.

In the last two decades of communism, Eastern Bloc countries started importing Western technology with credit financing. However, the inflexible management system of central planning was not able to use imported machines optimally. As international competitiveness grew only slowly, the international debt burden increased rapidly. The malfunctioning system was abandoned in 1989 in the former Eastern Europe.

In the early days of transition, all TEs were facing several serious problems. An overblown social welfare system formed a large part of the public expenditure in communist countries. In the post-communist economic slump, there were two options to maintain these expenditures: either fuelling inflation or imposing taxes that would curtail development of privatized firms, and thus, economic growth. Very high inflation rates could be observed in all TEs in the early years of post-communism.

The very core of the market economy is to allocate resources via the market. Stock exchange and a viable banking sector are *conditio sine qua non* (absolutely necessary preconditions) in the decentralized market economy.

In the post-communist era it is often maintained that the achievements of the Eastern Bloc countries in privatizing their economies are unprecedented: no other region has ever privatized as much of its economy as quickly. However, there were country-wise differences in both methods and speed. Romania and Bulgaria are said to be laggards in this sphere.

In the communist era, it was customary to exaggerate economic results. Production – sold and unsold – was added into economic aggregates. Positive figures were appreciated by communist leaders. Therefore it is difficult to compare gross domestic product (GDP) figures of communist period with equivalent data of transitional period.

European Bank for Reconstruction and Development (EBRD) was established in the early 1990 to allocate credits to TEs. This special Bank is situated in London City and publishes annual reports on TE-region. EBRD has estimated the long-term growth trend in every single TE.

**Table 2. Economic growth, real GDP in 2004**

	<b>1989 = 100</b>
Czech Republic	114
Estonia	112
Hungary	120
Latvia	90
Lithuania	89
Poland	142
Slovakia	121
Slovenia	126
NMS-8, average	126
Bulgaria	89
Romania	100

Source: EBRD (2005)

The above table lists all post-communist new member states of EU including Bulgaria and Romania. In all TEs, overall output decreased in the early period of transition. Economic growth resumed first in Poland, already in 1992, after which growth accelerated remarkably in the 1990s. Thus, it is understandable that Poland is scoring far the best result in the above table: its GDP exceeds the 1989 level by no less than 42% in 2004. Slovenia and Hungary have the two next best results.

Within NMS-group of countries, Latvia and Lithuania have both a marking below 100. It means that these two post-Soviet countries had in 2004 not yet reached the output level of 1989, which is clearly exceeded in the third post-Soviet republic, Estonia. The average figure of NMS-8 is 126, which indicates that TE-members of EU are clearly better off than in 1989 (with 26% over the 1989 level).

Bulgaria's output in 2004 was 11% lower than in 1989. This dismal result is directly linked with very serious economic policy-making mistakes in the mid-1990s. Romania's equivalent figure is better, just 100: in 2004 the output level in Romania was just as modest as in 1989.

One of the most important institutional changes of the transitional period in Bulgaria was the introduction of a currency board arrangement (CBA), which took place July 1st, 1997. Before that, ex-communist government in Bulgaria had made a terrible mess of the local economy with rapidly increasing inflation combined with a slump. This socialist cabinet was ousted by the United Democratic Forces led by Ivan Kostov in the autumn 1996. The new government started immediately to prepare the introduction of the CBA.

The CBA is a special system, which has been used and still is used in several countries. Thus, the system, which is not very well known, is worth to be clarified.

The CBA was originally a colonial invention designed to make monetary policy in far-off lands manageable. In its classical form, the CBA did away with the need for a central bank, and was run by a few specialists from afar. The system was rejuvenated in 1983 in Hong Kong to stabilize an economy that had gone into tailspin over fears of the British colony's hand-over to China.

In the transitional period of Eastern Europe, the CBA is not an unknown factor. The Estonians, newly independent and anxious to avoid importing inflation from Russia, introduced the CBA in 1992, along with a new currency, the kroon (EEK). The impact was an immediate success, and the Estonians turned into one of the star reformers in the TE-region.

The CBA system puts monetary policy on automatic pilot and ties local interest rates and therefore inflation to an international anchor economy. The system has three basic characteristics, which distinguish it from a standard fixed exchange rate regime:

- Domestic currency is pegged to an anchor currency (typically dollar or euro, or a basket of currencies) at a rate that cannot be adjusted.

- The amount of local money in the economy has to be fully (100%) covered by foreign reserves.
- The currency board cannot lend to the government or to the banking system.

The main idea behind the CBA is that it makes policy choices much simpler by taking most of them out of the realm of political debate. Governments cannot borrow money from the central bank, because the system locks up the money pump. The central bank cannot bail out insolvent banks, and insolvent banks cannot continue lending to technically bankrupt companies.

Obviously, governments and central banks only agree to tie their hands behind their backs (by introduction of the CBA), because it is the only way to restore their credibility at home and abroad. Increased credibility is supposed to bring monetary stability. In the pre-CBA Bulgaria, there was no faith in local policy-making among international investors.

Quite clearly, the CBA can only create macro-economic stability, but not guarantee successful structural reforms and economic dynamism. The CBA system cannot automatically bring about an overall success.

In Bulgarian case, the local money (lev or BGL) was pegged to German mark (DEM) at a rate BGL 1.000 = DEM 1. Peg switched from DEM to Euro on January 1st, 1999 with the rate BGL 1.956 = EUR 1.

Both Romania and Bulgaria have suffered a clear population decline in the transitional period. In 1990, Romania's population in its territory of 238 square kilometres was 23,2 million. The equivalent figures in Bulgaria were 111 square kilometres, and 8,7 million, respectively. In 2005, Romania had 21,7 million inhabitants and Bulgaria 7,8 million people. Obviously, modest economic performance has caused net emigration.

### **3.2 Structural Aspects**

Both Romania and Bulgaria provide very good preconditions for agriculture. This sector was in communist period rather neglected and used as a pool of surplus labour for newly built industries. Both countries also provide plenty of options in tourism (on the Black Sea, mountains). Tourism was an important "hard currency" earner in the communist era, but

belonged to service sector which was ideologically suspect: industrial production had absolute priority in communist preference scale.

One of the traditional ways measuring development stage in different countries is to count the value added share of agriculture (as percentage of GDP). Details in this respect are annually given by The World Bank (IBRD).

**Table 3. Value added as % of GDP, 2004**

	<b>Agriculture</b>	<b>Industry</b>	<b>Services</b>
Bulgaria	10	27	63
Romania	13	40	47

Source: IBRD (2006)

The share of agriculture in the Bulgarian value added creation is rather modest, only 10%. The equivalent figure in Romania is somewhat higher, 13%.

In these two TEs with a modest living standard there are obviously plenty of small farming units living in self-sufficiency, or very close to it. These units have very thin links with the monetary economy, and thus, their real contribution to local economy cannot be handled in full in statistics. Value added contributions must be measured in monetary terms.

The above table shows amazingly clear difference in Bulgaria's and Romania's industrial structure. In the former country, value added share of industry is only 27%, while the latter has an equivalent figure of no less than 40%. The mirror image of these figures is visible in the service sector: it dominates clearly in Bulgaria (63% of value added), and less so in Romania (47%).

These figures indicate that industrial restructuring has been especially difficult in Bulgaria. Many manufacturing units have not been able to survive the post-communist demand reshuffle. Bulgarian enterprises, which in the period of central planning were heavily involved in serving the Soviet market, have in many cases not been able to find new clients under market circumstances. The weight of manufacturing in the Romanian economy is thus substantially stronger than in Bulgaria.

The World Bank provides some interesting details on agricultural productivity for two 3-year periods. These figures indicate that the rural economy has advanced greatly in the post-communist period.



**Table 4. Agricultural productivity (aggregate value added per worker, in USD of 2000)**

	1989–1991	2001–2003
Bulgaria	2.434	6.310
Romania	2.079	3.430
Finland	16.056	30.391

Source: IBRD

The figures above cover the actual transition period (1989–1991), as well as three years in the 21st century. Finland is included to provide a comparison with two TEs under review. Figures are given in stable dollars (of year 2000), and thus, inflationary effects are eliminated.

Value added per agricultural worker more than doubled in Bulgaria in the first decade of transition (growth 159%). The equivalent growth in Romania was clearly more modest, only 65%. Thus, every agricultural worker created in the early years of the new century in Bulgaria almost twice as much value added than in Romania. The difference is striking.

Even more striking is the productivity difference between Finland and two TEs in the table. A person in the Finnish rural economy creates about 9 times more value than an equivalent person in the Romanian countryside and five times more than its Bulgarian colleague. In Finland, the productivity figure under discussion almost doubled between the two 3-year periods mentioned in the above table. Finland joined EU in between, in the middle of 1990s.

### 3.3 Foreign Trade and FDI

In the first half of the 20th century, Romania was a relatively important oil producer. However, its oil reserves were basically exhausted in the communist era. Romania and Bulgaria have no extensive resource base of mineral wealth. Thus, these countries have no easy way to earn foreign currency by exporting raw materials in massive scale.

**Table 5. Foreign trade, 2005 (in USD, bn)**

	Export	Import
Bulgaria	11,7	17,1
Romania	27,7	37,3
CEE	286,0	292,6
Baltics	24,9	32,6

Source: EIU

Merchandise trade in Bulgaria is on a very modest level. Annual export figure is less than USD 12 billion, which is less than half of the equivalent in Baltics with 7,1 million

inhabitants (Estonia, Latvia, Lithuania). The latter imports almost twice as much as the former.

Romania's export of goods has annual value of about USD 28 billion. Central-East European countries (CEE) export in total value of USD 286 billion. The population of CEE is with 66 million about three times higher than that in Romania, but the export value of CEE is ten times the Romanian figure. Romania's import exceeds somewhat the equivalent in the Baltics, in which the population is about one third of the Romanian figure. In sum, foreign trade figures in relative terms both in Bulgaria and in Romania are rather modest.

Foreign Direct Investment (FDI) inflow is in many sense essential for TEs, which at least potentially suffer of capital shortage. FDI is part of the "risk capital" movement, and thus, FDI does not need to be serviced by the host country, unlike outside debt. FDI is said to help host country development because of the technology and techniques that come with it. Over the long term, FDI may be more expensive form of finance than debt because the outflow of remitted profits usually gives this kind of investor a bigger return than a foreign bank or bondholder could expect to receive.

FDI has exercised a very decisive influence in the development of TE-region, especially by enhancing export capability and import substitution (for details, see T. Tiusanen: *Foreign Investors in Transitional Economies: Cases in Manufacturing and Services*. NORDI publication No. 27, Lappeenranta 2006). FDI stock in TE-region is unevenly distributed: investment climates within the group vary.

There is no unified system in collecting FDI data. Therefore, FDI figures show differences, which are not necessarily large. One of the organisations following the FDI regularly and collecting data on the topic is The Economist Intelligence Unit (EIU). This unit also publishes regularly a business environment index comprising emerging markets, TEs included. This composite index has quantitative and qualitative components. The composite index comprises 67 elements, and assessment includes 82 countries.

**Table 6. Foreign direct investment stocks, 2005**

	<b>FDI stock (USD bn)</b>	<b>FDI stock per head (USD)</b>
<b>CEE</b>	<b>198,2</b>	<b>3.011</b>
Czech Republic	55,1	5.382
Hungary	48,8	4.878
Poland	75,7	1.984
Slovakia	13,8	2.539
Slovenia	5,3	2.701
<b>Balkans</b>	<b>61,0</b>	<b>1.134</b>
Albania	1,7	545
Bosnia and Hercegovina	2,1	529
Bulgaria	12,3	1.601
Croatia	12,5	2.735
Macedonia	1,3	642
Romania	24,5	1.115
Serbia and Montenegro	6,7	829
<b>Baltics</b>	<b>18,1</b>	<b>2.551</b>
Estonia	8,0	5.941
Latvia	4,5	1.950
Lithuania	5,6	1.624

Source: EIU

According to EIU, a total sum of almost USD 200 billion has been invested in CEE region in direct form. In this area, FDI stock per capita exceeds USD 3.000. Czech Republic and Hungary are the most successful CEE-countries in attracting FDI: the former has a per capita figure of over USD 5.000, and the latter a bit below this figure.

The second group called “Balkans” has a FDI stock of over USD 60 billion, which in per capita terms is about one third of the CEE figure, or over USD 1.000. In this group the most successful country with a per head figure of USD 2.700 is Croatia, which is a former state of Yugoslavian Federation. Bulgaria is with an equivalent figure of USD 1.600 on the second place and Romania on the third (USD 1.100).

In the Baltics the absolute figure of FDI is about USD 18 billion and the relative figure (per capita) USD 2.550. The best performing country of the above table is Estonia, one of the Baltic States: its per capita FDI stock is close to USD 6.000, which is more than equivalent figure in Czech Republic.

It is often pointed out that FDI flows into TE-region were affected by possible EU-entry of TEs in the early period of transition. If that assumption is correct, it is likely that Bulgarian and Romanian entry into EU will accelerate their FDI inflow in the future.

The Vienna Institute for International Economic Studies (WIIW) provides information on FDI inward stock, by country of origin as well as by activities. Table below contains seven TEs, all of which are members of EU in 2007. The Baltic states are not included.

**Table 7. Foreign direct investment inward stock, by country of origin (as of December 2005, shares in %)**

	<b>BG</b>	<b>CZ</b>	<b>HU</b>	<b>PL</b>	<b>RO</b>	<b>SK</b>	<b>SI</b>
Austria	33,8	11,2	11,4	5,0	15,7	14,7	28,9
France	3,1	6,6	4,7	13,4	10,3	2,7	8,7
Germany	3,9	20,6	29,2	16,6	8,6	19,6	8,7
Greece	10,8	0,0	N.A.	0,0	8,2	0,0	0,0
Italy	6,9	1,2	1,7	3,9	4,8	7,0	5,8
Japan	0,4	1,5	1,7	0,6	N.A.	0,3	0,3
Netherlands	2,0	32,6	17,7	23,6	16,3	21,9	10,6
United Kingdom	6,8	3,7	0,8	3,0	0,4	6,6	1,6
United States	3,4	5,2	4,5	7,3	4,3	3,9	1,6

Source: WIIW (2006)

Austria is very clearly the leading foreign direct investor in Bulgaria with about one third of the overall FDI stock. Also in Slovenian FDI scene Austria has a predominant position of almost 30% of the inward stock. In Romania Austrian firms have a rather high share of almost 16% of local FDI stock, which is marginally less than the Dutch figure of over 16%. Austria has in the above table double digit numbers in all other countries except Poland. As Austria has a dominant historical role in the CEE-region it is not surprising to observe its intensive investment activities in the neighbouring countries. Vienna is hosting many international companies with investment schemes in TE-region. Many of these companies have established their Central Eastern European headquarters in Austria. Obviously, many Austrian FDIs in TE-region are made by non-Austrian firms via their Viennese daughter companies.

Netherlands is the most important foreign direct investor in Romania with a share of over 16% of FDI stock. Dutch banking institutions have been active in TE-region creating presence in several countries of the area. Many multinational companies from America and Asia have their European headquarters in Netherlands, many of which invest in TE-region via their Dutch subsidiaries. It may be one of the reasons why US and Japanese companies have rather modest shares in the above FDI table.

France is on the third place in Romania's inward FDI statistics. The most spectacular French FDI in Romania is acquisition of the Romanian car-making unit, Dacia, which was made by Renault. In the communist era, Renault cars were produced by Dacia with French license.

German companies have invested heavily in the TE-region. However, Germany is in the leading position in FDI statistics only in Hungary, as the above table shows. In Romania and Bulgaria German FDI figures are relatively modest. Alongside with Hungary, Poland, Czech Republic and Slovakia have been the most important transitional playing grounds for German multinationals.

It is rather surprising that Greece is the second most important FDI country in Bulgaria with an almost 11% share of the overall inward stock. Greece has also established a relatively strong presence in Romanian investment scene, where it has an over 8% stake of FDI stock.

Italian and British investors have shown rather modest interest in transitional economies. Bulgaria has attracted in relative terms more British FDIs than any other TE in the above table. Both Italy and United Kingdom have a share of less than 7% in the Bulgarian inward FDI stock.

US companies have been rather passive in the TE investment scene. In Poland about 7% of FDI capital comes from America. In Romania the equivalent figure is just over 4% and in Bulgaria over 3%.

TE-region offers relatively low labour costs to supply-oriented investors (see table below). Increasing living-standard in the region attracts more and more market-seeking investors. FDI scene in TEs by activities contains several interesting details.

**Table 8. Foreign direct investment inward stock, by activities (as of December 2005, shares in %)**

	<b>BG</b>	<b>CZ</b>	<b>HU</b>	<b>PL</b>	<b>RO</b>	<b>SK</b>	<b>SI</b>
Mining and quarrying	0,9	1,3	0,1	0,2	8,1	0,6	0,0
Manufacturing	12,8	40,1	44,2	37,9	45,7	40,1	43,7
Electricity, gas and water supply	0,2	6,7	4,0	3,6	0,6	9,5	4,5
Construction	23,4	1,9	0,9	1,9	1,1	0,7	0,3
Wholesale, retail trade, repair of veh., etc.	3,8	12,9	10,1	17,9	14,5	13,0	14,0
Hotels and restaurants	10,3	0,9	0,8	0,5	0,2	0,5	0,4
Transport, storage and communication	1,1	6,2	9,9	7,6	11,6	8,7	3,7
Financial intermediation	34,9	16,5	10,5	19,7	11,4	21,8	19,7
Real estate, renting & business activities	9,6	11,3	16,8	9,5	5,6	3,8	12,9

Source: WIIW (2006)

Manufacturing is very obviously the most important branch favoured by foreign direct investors. More than 40% of the FDI stock is invested in this activity in Czech Republic, Hungary, Romania, Slovakia and Slovenia. In Poland the equivalent figure of almost 38% is not far away from the 40% borderline. Bulgaria is in this context an exception: only about 13% of its inward FDI stock is in manufacturing branch, even though its wage level is the lowest in the region under review.

Within the service sector there are two categories of high importance: financial intermediation and trade. The former sphere takes about 20% of FDI stock in Poland, Slovakia and Slovenia. The equivalent figure in Bulgaria is with 35% extremely high. The latter has attracted 10–18% of FDIs in Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. In Bulgaria the equivalent figure is exceptionally low, less than 4%.

Transport, storage and communication is an attractive service category from the point of view of Western companies. In the communist era, the state had monopoly in telecommunication running fixed line telephone services very badly. In the early period of transition mobile phone operators started appearing on the scene. Foreign companies invested heavily in this branch, and therefore, FDI shares in this activity are relatively high. Bulgaria is also in this context exceptional: only about 1% of FDI is in this category.

Hotel and restaurant business has only marginally attracted inflow of FDI in TE-region, except in Bulgaria, where this branch takes about one tenth of FDI stock. This figure is not necessarily surprising, because Bulgaria offers excellent preconditions for intensive tourism. Also in construction branch Bulgaria delivers amazing results: about one quarter of FDI stock can be found in this category. In other TEs of the above table have only marginal FDI-shares in this sphere.

Real estate agents and developers have obviously had a golden period in the era of early transition. Beautiful capital cities in the region under review have experienced a fundamental face-lifting. Foreign capital has eagerly participated in this operation. This branch has attracted almost 17% on Hungarian FDI stock. Equivalent figures in Bulgaria, Czech Republic, Poland and Slovenia are about ten percent, or more. Romania (5,6%) and Slovakia (3,8%) have both rather modest figures in this context.

TEs under review here have rather modest mineral resources. Thus, it is understandable that mining does not play a key role in attracting FDI. However, there are some exceptions – for

example, gold is mined in Romania by a foreign company. About 8% of FDI in Romania is active in the sphere of mining.

Obviously, EU-membership or non-membership is only one aspect of the so called investment climate in TEs. Foreign investors go through a multitude of factors affecting business in a potential FDI host-country.

Presently, there are several composite indexes published regularly on business environment. These statistics are made in order to help international investors in their decision-making. EIU's latest composite index is the source of the table below. The table contains ten TEs in alphabetical order.

**Table 9. Business environment rankings**

	2001-05 Total score <sup>1</sup>	2001-05 Global rank <sup>2</sup>	2006-10 Total score <sup>1</sup>	2006-10 Global rank <sup>2</sup>	Change in total score	Change in rank	Grade* 2001-05	Grade* 2006-10
Bulgaria	5,87	49	6,77	43	0,89	6	moderate	good
Czech Republic	6,92	28	7,45	27	0,53	1	good	good
Estonia	7,65	19	7,93	20	0,29	-1	good	good
Hungary	6,72	34	7,29	33	0,57	1	good	good
Latvia	6,69	36	7,17	34	0,48	2	good	good
Lithuania	6,60	39	7,16	36	0,56	3	good	good
Poland	6,64	38	7,16	35	0,52	3	good	good
Romania	5,64	53	6,48	48	0,84	5	moderate	moderate
Slovakia	6,77	31	7,52	24	0,74	7	good	good
Slovenia	6,71	35	7,33	31	0,62	4	good	good
World average	6,33	-	6,80	-	0,47	-	moderate	good

\*Qualitative grades are assigned according to the following scale: very good, score more than 8; good, 6,5-8; moderate, 5,5-6,4; poor, 5-5,4; very poor, less than 5.

<sup>1</sup> Out of 10 countries.

<sup>2</sup> Out of 82 countries.

Source: EIU

In the total score the average of index components is counted, whereby the potential maximum is 10 points. The table covers two periods (2001–2005 and 2006–2010), which means that it tries to shed light on the future development prospects of countries involved and allows comparisons between these two periods.

The best-scoring TE in the table is Estonia, which is in rank 20 out of 82 countries. However, its rank dropped one point in comparison to the previous assessment. Its total score has improved somewhat.

Estonia has the highest per capita FDI and the highest rank in the EIU assessment concerning business environment. The second-best TE in the above table, Slovakia (rank 24), has rather modest FDI stock per capita, which is even below CEE average figure. Slovakia's rank in EIU assessment has improved strongly, from rank 31 in 2001–2005 to 24 in 2006–2010. In the first years of the new century, FDI inflow in Slovakia has increased substantially in comparison to the 1990s. Thus, the improvement of the investment climate is a concrete fact.

Czech Republic has the 27th global rank in EIU assessment and the highest FDI stock per capita within CEE. Slovenia is the next one in 31st position in global ranking, but its FDI stock per capita is only about half of the Czech equivalent figure. Hungary with a high relative FDI stock is in rank 33 in business environment table. Latvia, Poland and Lithuania occupy the next places (34–36) in the global ranking. Each of these countries has relatively modest FDI stock per capita.

Bulgaria's global rank is 43, clearly below all NMSs mentioned above. However, Bulgaria's rank in the latest assessment (for 2006–2010) has improved essentially from the 49th position in the previous index. Its overall grade improved from “moderate” (2001–2005) to “good” 2006–2010. FDI inflow in Bulgaria has grown strongly in 2003–2005.

Romania's global rank (48) is the worst in the table covering 10 TEs. Romania has also been able to improve its ranking from 53rd position to 48th place. Overall grade in 2006–2010 is, however, still “moderate”. In spite of that, FDI inflow is increasing. None of TEs covered in the EIU assessment gets an overall grade of “very good”, nine get “good” and Romania “moderate”. Estonia went one step down in ranking, while all other countries under review improved their rankings, Slovakia and Bulgaria rather dramatically. Estonia still has got the best business climate within TE-region.



## **4 Economic Dynamism 2001–2005**

### **4.1 Growth and Stability**

In the communist era, every centrally planned economy had a five-year plan. None of them met the planned target in the 1970s and 1980s in the Eastern Bloc.

In the early period of transition, all TEs were facing poorly competitive and in many cases nonviable production capacities. Therefore, the systemic change called for restructuring and austerity to restore the potential for market-dominated wealth creation. There was a very clear temptation in the economic policy-making: combating decreasing production with increasing money supply. In the hindsight the result was clear. A period of “stagflation” took place. Decreasing production was followed by strong inflation.

It is not the topic of this short report to study the difficult days of early transition in TEs. It suffices to state here that it took time in TEs to realize that relative stability is a *conditio sine qua non* for sustainable economic growth with enough incentives for investment activity. Under circumstances of strong inflation there is always the danger of essential capital flight and brain drain.

As pointed out above, economic growth performance has been very uneven in the TE-region. In Bulgaria and Romania it took several years, before the link between relative stability and optimal economic growth was recognised. That is one of the major reasons why Bulgaria and Romania were unable to join EU in 2004 alongside with 8 NMSs. The second decade of transition is by definition easier to manage than the first one. Thus, the text below deals with the early years of the 21st century.

In the early period of transition, it was essential to create favourable investment climate. Investment deserves special attention because it is important for the future health of an economy.

Investment is spending on physical assets necessary for future production. This should be distinguished from financial transactions, which are known as investment in everyday language but which are in economic terminology savings.

Economists call new investment in physical assets “gross domestic fixed capital formation” (GDFCF). Gross because it is before depreciation, domestic because it is at home and not overseas, fixed because it does not include stocks, and capital formation since it distinguishes physical from financial investment.

Physical assets include buildings, such as dwellings, factories and offices; machinery, vehicles and equipment; infrastructure such as docks, airports and roads. Businesses are main investors, but also public sector is involved (in building schools, roads, etc). Almost all personal spending is consumption for national accounts purposes, except the purchase of new dwellings. Public sector may invest in new dwellings and allocate them (renting) to people without private dwellings.

Investment is financed by savings. If a country invests more than it can finance with local savings, it must import capital (savings taking place abroad). A country with abundant savings, which cannot be absorbed by local investment activity, exports capital.

Investment activity declined in both Bulgaria and Romania in the 1990s, which is visible in the table below. The level of investment in 1989 is marked with 100. NMS-countries in CEE are included to provide material for comparison.

**Table 10. Gross fixed investment in 1999**

	<b>Index 1989=100 1999</b>
Czech Republic	103,4
Hungary	125,3
Poland	203,5
Slovak Republic	103,5
Slovenia	164,0
Bulgaria	58,6
Romania	47,9

Source: WIIW

Investment more than doubled in Poland during last decade. Also Slovenia had dynamism in its investment in the early period of transition with over 60% growth in the given period. Hungary’s equivalent figure of 25% is rather moderate. Investment in Czech Republic and Slovakia virtually stagnated in the 1990s.

As mentioned above, Bulgaria and Romania applied EU membership in the 1990s, but were not allowed to enter the Union in 2004 alongside with other eight TEs. The most important

reason for this relegation was the slow pace of institutional reforms, and thus, emergence of an unfavourable investment climate. In Bulgaria, investment decreased by some 40%, and in Romania even over 50% in the previous decade. There was a real danger that these two former members of the Eastern Bloc will enter a “poverty trap” with permanently decaying economy.

Investment scene in the early years of the 21<sup>st</sup> century differs radically from the 1990s. The index below marks 2000 with 100.

**Table 11. Gross fixed capital formation in 2005, real**

	<b>Index 2000=100 2005</b>
Bulgaria	198,0
Czech Republic	123,8
Hungary	139,5
Poland	95,4
Romania	156,1
Slovak Republic	128,1
Slovenia	117,1

Source: WIIW

Investment activity has almost doubled in Bulgaria between 2000 and 2005. Also Romania shows rather strong increase in its real investment of 56% in the same time frame. In Poland, a strong investment boom in the 1990s is followed by a moderate decline of 5% in 2000–2005. Other CEEs in the table above show growth rates, which are more moderate than in Romania and clearly below Bulgaria’s achievement.

There is a very clear message in the two previous tables: the investment scene both in Bulgaria and Romania changed radically in the turn of the century. Growth in real investment has created preconditions for sustainable growth.

**Table 12. Gross domestic product in 2001–2005, annual real change (%)**

	<b>2001</b>	<b>2002</b>	<b>2003</b>	<b>2004</b>	<b>2005</b>
Bulgaria	4,1	4,9	4,5	5,7	5,5
Romania	5,7	5,1	5,2	8,4	4,1

Source: WIIW

In both countries under review, overall economic growth in the early years of the 21<sup>st</sup> century is on a healthy basis. Exceptionally strong GDP growth of over 8% in Romania is influenced by very good harvest.

Without this special factor it can in general terms be maintained that Bulgarian and Romanian economies show an annual growth of roughly 5%.

In the sphere of price stability (measured by consumer price index, CPI), Bulgaria shows a clearly better performance than Romania.

**Table 13. Inflation in 2001–2005, CPI change p.a. (%)**

	2001	2002	2003	2004	2005
Bulgaria	7,4	5,8	2,3	6,1	5,0
Romania	34,5	22,5	15,3	11,9	9,0

Source: WIIW

In Bulgaria inflation figures are relatively well under control, which is mainly due the currency board system applied in the country. In 1997, Bulgaria's inflation rate per annum was over 1.000%. Thus, the new system (currency board) was virtually a necessity to control inflation.

In 2001–2003, inflation rate decelerated clearly in Bulgaria. However, inflation figures in 2004–2005 were higher than in 2002. Annual CPI increases of 5–6% do not signal final price stability.

Romania applies a managed floating exchange rate policy. Thus, it is understandable that inflation rates are higher in Romania than in Bulgaria. Currency board by definition has a stabilizing effect in a country using the system.

Romania's inflation rates show a decelerating tendency in the above table: the rate of inflation has come down from near 35% in 2001 to 9% in 2005. However, the latter figure is still far away from real price stability.

In the European Monetary Union (EMU) there are certain preconditions to be met by potential new members of euro-zone, which are defined in Maastricht Treaty. There are two major rules in this "stability pact": budget deficits are not supposed to exceed 3% of local GDP in any year; public sector debt is not allowed to be over 60% of the local GDP. It is a well-known fact that these rules are not strictly observed by all euro-zone members.

**Table 14. Fiscal policy in 2001–2005, budget deficit (-), surplus (+), % of GDP**

	2001	2002	2003	2004	2005
Bulgaria	-0,6	-0,7	0,0	1,7	3,2
Romania	-3,2	-2,6	-2,2	-1,2	-0,8

Source: WIIW

Fiscal policy in Bulgaria shows clear prudence in 2001–2005. There are moderate budget deficits less than 1% of GDP in 2001–2002. The state bookkeeping was in balance in 2003, while in 2004–2005 budgets show annual surpluses. Revenue exceeds expenditure by far in 2005: surplus is over 3% of GDP.

In Romania budget deficit exceeded the Maastricht limit of 3% of GDP moderately in 2001. In 2002–2005 deficits have declined permanently, which means that also Romania's fiscal policy is well under control.

**Table 15. Public sector debt in 2001–2005, % of GDP**

	2001	2002	2003	2004	2005
Bulgaria	66,2	53,2	46,2	38,8	31,9
Romania	23,2	23,8	20,7	18,0	15,2

Source: WIIW

In Bulgaria public debt exceeded the critical 60% of GDP limit in 2001, but the figure has decreased rapidly in 2002–2005. The result of 2005 is with only some 32% of GDP an encouraging one.

Comparative figures in Romania are even essentially better. The first marking (2001) is with 23% of GDP already moderate, but the last one in the table (2005) is very low with only somewhat over 15%.

Positive tendencies in the above table in both countries under review are linked with privatization process. State-owned assets were turned into private hands relatively slowly in Bulgaria and Romania. Thus, these two TEs have been able to reduce their respective public sector debts with income originating from asset sales in 2001–2005. Especially in Romania the relative figure of public sector debt is extremely encouraging.

## 4.2 External Economy

In fast-growing emerging economies there is the danger of “overheating”. It is possible that amid a booming economy prices increase rapidly hurting international competitiveness of the country. In that case, imports may increase faster than exports hurting the external equilibrium measured by current account (CA). If import demand (of goods and services) permanently exceeds export earning capabilities, a balancing act may become necessary. One option in this context is to dampen overall demand and hope that it will cool down import growth.

In economic terminology it is said that there is “current account constraint” in the growth process. Frequently, CA problems are taken care of by devaluation of the local currency. A multitude of devaluations took place in the global economy of the 1990s.

Current account deficits are measured in relative terms (as percentage of GDP). It is often said that CA deficits over 10% of GDP are not sustainable.

Current account deficits must be financed by capital import. In this context, there are two basic options, either taking credits from abroad, or attracting risk capital inflow. In the latter case, there are two subcategories: portfolio equity investment and foreign direct investment (FDI).

Every market economy has a stock exchange (or several). Let us assume that a German pension fund buys shares in a Romanian oil refinery for EUR 1 million. The fund cannot manage that company with the stake of EUR 1 million. This portfolio equity investment is done, because the investor expects its stake to increase in value in the future. In addition, portfolio investors hope for a dividend (a share of refinery’s potential profit). If the refinery goes bust, the portfolio investor suffers a loss.

Foreign direct investor risks his capital by buying or creating an enterprise abroad, in which the investor asks for management influence. Obviously, dominance in a foreign company cannot be achieved with a marginal stake.

Every foreign debt must be serviced (the debtor pays interest and part of the borrowed money back as scheduled to the creditor). Extensive indebtedness drives interest rates up. Occasionally, nations cannot service their external debts. The case of non-payment is called defaulting.

Debts of defaulting countries are either rescheduled (the payment time is prolonged) or crossed over (forgiven).

There is plenty of evidence that FDI in TE-region has alleviated CA problems. Very often FDI generates export income and/or substitutes imports. Thus, FDI is a convenient method of capital import. The host country of FDI is not burdened with debt servicing.

**Table 16. Current account in 2001–2005**

	2001	2002	2003	2004	2005
<b>Bulgaria</b>					
CA, EUR bn	-1,1	-0,9	-1,6	-1,1	-2,5
CA, % of GDP	-7,3	-5,6	-9,2	-5,8	-11,8
FDI inflow, EUR bn	0,9	1,0	1,9	2,7	1,8
<b>Romania</b>					
CA, EUR bn	-2,5	-1,6	-3,1	-5,1	-6,9
CA, % of GDP	-5,5	-3,3	-5,8	-8,4	-8,7
FDI inflow, EUR bn	1,3	1,2	1,9	5,2	5,2

Source: WIIW

In the period under review here (2001–2005), Bulgaria's CA as a percentage of GDP has fluctuated between -5,6% (2002) and -11,8% (2005). In the five-year period the inflow of FDI of EUR 8,3 billion exceeds the sum of CA deficits (EUR 7,2 billion). In the light of these figures, Bulgaria has conveniently been able to finance its CA deficits with FDI inflow in this decade.

The picture in Romania is not essentially deviating from Bulgarian equivalent. The sum of CA deficits in 2001–2005 is EUR 19,2 billion, of which EUR 14,8 billion is covered by FDI inflow in the same period. In euro terms, CA deficits are slightly overcompensated by FDI inflow in Bulgaria, while in Romania there is some undercompensation. However, in the light of these figures, neither Bulgaria, nor Romania faces a serious CA problem in the second decade of transition. There is a healthy inflow of FDI in countries under review.

Currencies in all TEs are continuously clearly undervalued (see T. Tiusanen: Foreign Investors in Transitional Economies: Cases in Manufacturing and Services. NORDI publication No. 27, Lappeenranta, 2006). However, the magnitude of undervaluation varies within TE-group. Thus, TEs exercise exchange rate protectionism: undervalued currency gives price competitiveness in exports and keeps import prices disadvantageous in comparison to local product prices.

The Vienna Institute for International Economic Studies (WIIW) has long experience in calculating purchasing power parity (PPP) adjusted exchange rates (ERs) in TE-region. By comparing official (average) ER with the PPP adjusted one the degree of currency undervaluation can be determined.

**Table 17. Exchange rates, local currency/EUR**

	2001	2005
<b>Bulgaria</b>		
A. Official ER	1,956	1,956
B. PPP adj. ER	0,643	0,720
C = A/B	3,04	2,72
<b>Romania</b>		
A. Official ER	2,603	3,623
B. PPP adj. ER	0,955	1,631
C = A/B	2,73	2,22

Source: WIIW

As mentioned above, Bulgaria has a fixed ER regime against euro combined with currency board's arrangement. Thus, lev (Bulgarian money) has stable ER against euro in both years of the table (2001 and 2005).

In the managed floating of leu (Romanian monetary unit), the official ER changes against euro. In this context it is worth mentioning that Romania introduced new banknotes in July 2005: one new leu equals 1.000 old ones. This kind of monetary reform takes place occasionally in countries, which have had strong inflation eroding the money value. Figures in the above table are given in new leu for both years (2001 and 2005).

In 2001, Bulgaria's lev was very strongly undervalued. Official ER divided by the PPP adjusted one gave a result of over three. This high level of undervaluation of Bulgarian currency in 2001 can be explained via an example. A person living in euro-zone can buy an average consumer basket of EUR 100 in the region of the monetary union. Local differences obviously can be observed in the price of the basket with identical content everywhere in euro-zone. The same EUR 100 bought in 2001 no less than three equivalent consumer baskets in Bulgaria.

As pointed out above, inflation in Bulgaria is still relatively high. With the fixed ER, currency depreciation is excluded. As the inflation rates are higher in Bulgaria than in euro-zone (in average), the price of Bulgaria's average consumer basket increases in relative terms, which means that there is an erosion of the undervaluation advantage. Official ER divided by PPP



adjusted one gives 2,72 in 2005. Thus, it can be maintained that Bulgaria has somewhat lost price competitiveness in 2001–2005 period. The change in this respect is relatively moderate.

In 2001, Romania's undervaluation was a bit more moderate than in Bulgaria. Official ER divided by the PPP adjusted one was 2,73. The official Romanian leu ER has depreciated in 2001–2005 period, which is natural with rather high inflation rates and managed floating system. In the same period, PPP adjusted ER has grown more rapidly than the official ER, which in economic language means that leu has appreciated in real terms (undervaluation advantage has eroded from 2,73 in 2001 to only 2,22 in 2005).

Bulgaria and Romania are both TEs with considerable tourist income. Therefore, it is important that both of them have clearly undervalued currencies in order to offer cheap destinations for international tourists.

This point can be clarified with a concrete example by using Bulgarian figures from the above table in 2005. When a visitor from euro-zone enters Bulgaria, he/she gets 1,956 lev for every euro exchanged, which is 1,236 lev more than the PPP adjusted ER presupposes. Thus, the euro-zone visitor receives “an undervaluation bonus” of 1,236 lev per euro.

When a visitor of Bulgaria goes to euro-zone, he/she pays for every euro exchanged the official ER of 1,956 lev, and not the PPP adjusted price of 0,72 lev per euro. In this case, the Bulgarian visitor of euro-zone pays “an undervaluation penalty” of 1,236 lev per euro.

This scene is clearly very advantageous from the point of view of Bulgarian current account. Tourists visiting Bulgaria have the incentive of low prices during their holidays. Potential Bulgarian travellers to the euro-zone must carefully calculate their expenses linked with the trip. Thus, Bulgaria and several other TEs have a permanent surplus in tourist balance which is a component of current account.

Naturally, currency undervaluation also helps trade balance by creating special price competitiveness. Emerging markets frequently have clearly undervalued currencies.

Official ERs (A-figures above) and PPP-adjusted ERs (B-figures in table) ought to be identical: official exchange rates should reflect local prices correctly ( $A/B = 1$ ). In that case ER is said to be in equilibrium (in parity).

Slovenia, the best-off TE, has almost reached equilibrium in its ER. Romania and Bulgaria still need the advantage of undervaluation but that advantage is in decline, as the above table shows.

### 4.3 Labour Market

The communist economic model of forced urbanization of the society moved millions of people from the countryside into industrial centres. Full employment combined with low productivity became the rule. It was advantageous for enterprises in the central planning system to hoard all resources, workers included. Increasing plan targets had to be met, and thus, reserves were rational from the point of view of the system.

In the context of the systemic change it very soon became evident throughout the post-communist region that overmanning was a serious problem in the enterprise sector. In the post-communist slump, also the public sector had to rationalize the use of people. Open employment came into being.

It was mentioned above that Bulgaria was closely linked with the former Soviet Union in the communist era. In 1990, total employment in Bulgaria was 4.097.000. In 2000 the equivalent figure was 2.980.000.

Romania had very weak competitiveness in its communist industry. Thus, the trend in Romanian employment is rather similar than in Bulgaria: there were 10.840.000 employed persons in 1990 and 8.629.000 in 2000.

It is not the aim of this report to describe details of the labour market in the 1990s in Bulgaria and Romania. It suffices to say that in these two countries restructuring of the labour market after communism has not been an easy task.

**Table 18. Unemployment in 2001–2005, LFS definition\***

	In 1.000 persons					Rate (%) of labour force				
	2001	2002	2003	2004	2005	2001	2002	2003	2004	2005
Bulgaria	664	592	449	400	334	19,7	17,8	13,7	12,0	10,1
Romania	750	845	692	799	705	6,6	8,4	7,0	8,0	7,2

\* LFS = Labour Force Survey

Source: WIIW

The Bulgarian unemployment rate in 2001 was close to 20% of labour force, which meant that over 660.000 people were without work. Amid economic boom the labour market has improved dramatically. In 2005, the equivalent figures were about 10%, and 330.000, respectively. Similar positive development has not taken place in any other TE in the same period of time.

Romania's GDP growth performance in 2001–2005 does not essentially deviate from Bulgaria's equivalent. However, Romania's boom has hardly affected the labour market. Unemployment rate was in 2001 with 6,6% rather modest, but has in 2002–2005 been 7–8%. In 2005 there were over 700.000 persons out of work in Romania.

**Table 19. Hourly wage, by profession (in USD)**

	<b>Factory Worker</b>	<b>Engineer</b>	<b>Accountant</b>	<b>Middle Manager</b>
Poland	3,07	4,32	4,03	6,69
Czech Republic	2,81	5,38	4,10	6,81
Hungary	1,96	5,09	4,62	7,44
Slovakia	2,21	4,15	3,37	5,48
Romania	1,41	2,58	1,23	3,23
Bulgaria	0,73	1,43	0,83	2,80
China	0,80	3,50	3,20	4,42
India	0,43	2,40	1,93	3,13
Germany	18,80	38,90	26,40	40,40

Source: Business Week (2005)

In hourly wage comparison Bulgaria is amazingly advantageous country. Factory workers earn about four times more in Poland than in Bulgaria, where the worker is even lower paid than in China. Romania's factory worker receives almost double the pay of Bulgarian equivalent. Engineers in Bulgaria receive even less compensation than in India. Romanian engineers earn more than their Bulgarian colleagues, but both are paid less than Chinese engineers.

Accountants in Bulgaria receive only a bit more pay than factory workers, who in Romania are better off than bookkeepers. Positions in middle management are better paid than engineers in both Romania and Bulgaria.

It is astonishing that Bulgaria is in all four categories of the above table more advantageous in hourly pay than China. Romania is in all four professions clearly more expensive than Bulgaria. Obviously, the extraordinary improvement of the Bulgarian labour market can at

least partially be explained by the hourly pay table above, which indicates that employing Bulgarians is very advantageous in international comparison.

There are several ways available in measuring labour costs and comparing them in international arena. One of them is gross average monthly wage, which tells to potential investors in a new target market how much an employer has to pay for an average wage earner a month. Obviously, international comparisons must be calculated in one currency, e.g. in US dollars or euros.

**Table 20. Average monthly gross wages in 2000 and 2005, EUR (ER)**

	2000	2005	Change 2000–2005, %
Bulgaria	115	164	42,6
Czech Republic	382	641	67,8
Estonia	314	513	63,4
Hungary	337	639	89,6
Latvia	267	341	27,7
Lithuania	262	368	40,5
Poland	472	584	23,7
Romania	142	268	88,7
Slovak Republic	268	448	67,2
Slovenia	935	1.234	32,0

Source: WIIW

In the above table containing ten TEs, Bulgaria is far the most advantageous country in nominal labour costs. Average monthly gross wage is only EUR 164, or about 13% of equivalent figure in Slovenia with the best pay in the region (EUR 1.234 a month).

Romania has the second lowest figure in the table with EUR 268 gross monthly pay. Slovenians earn almost 5 times more than Romanians in average. Bulgarians earn in average about EUR 100 less than Romanians. Czechs, Hungarians and Poles earn more than double in comparison to Romanians. Average monthly pay in Slovakia is with about EUR 450 rather modest but clearly higher than in Romania.

The monthly pay package has grown very fast in Hungary and Romania between 2000 and 2005. In both countries the increase is close to 90%. The equivalent figure in Bulgaria is essentially more modest, only about 43%. Thus, it can be assumed that Bulgaria will be able to offer the lowest labour costs in the region under review also in the second half of the current decade.

As pointed out above, official exchange rates do not reflect local price levels in transitional economies correctly. Purchasing power parity adjusted ERs deviate considerably from the official ones. This deviation is especially severe in the Bulgarian case.

**Table 21. Average monthly gross wages in 2000 and 2005, EUR (PPP)**

	2000	2005	Change 2000–2005, %
Bulgaria	365	444	21,6
Czech Republic	833	1.112	33,5
Estonia	597	867	45,2
Hungary	718	1.053	46,7
Latvia	531	695	30,9
Lithuania	568	746	31,3
Poland	915	1.070	16,9
Romania	397	563	41,8
Slovak Republic	626	817	30,5
Slovenia	1.299	1.681	29,4

Source: WIIW

In the light of the above figures with PPP adjustment, average monthly gross wages in TEs are clearly higher than the nominal ones. Therefore, monthly pay with purchasing power adjustment gives a more realistic and more optimistic picture of living standard among average consumers in TEs. These figures are especially interesting from the point of view of market-seeking investors, who are looking for supplementary demand in the international expansion.

In the transitional period Western retailers have had an interesting investment sphere in the TE-region (for details, see T. Tiusanen: *Foreign Investors in Transitional Economies: Cases in Manufacturing and Services*. NORDI publication No 27, Lappeenranta, 2006).

There are four countries in the above table with an average monthly gross wage over EUR 1.000, PPP adjusted. Slovenia is far the richest economy with almost EUR 1.700 a month, but also Czech Republic, Hungary and Poland exceed the EUR 1.000 limit. Estonia is approaching the EUR 900 mark.

Bulgaria has the most modest figure in the PPP-adjusted monthly pay with EUR 444. Romania is the second from the bottom of the scale with EUR 563 figure. These two countries with the combined population of almost 30 million are becoming interesting locations from the point of view of market-seeking investors.

Development of PPP adjusted monthly pay in 2000–2005 shows dynamism. Three TEs – Hungary, Estonia and Romania – have growth rates of over 40%, in the given period. Poland (about 17%) and Bulgaria (about 22%) have the slowest growing monthly pay packages with PPP adjustment.

Supply-oriented investors are interested in cheap inputs, labour costs included. In the sphere of manufacturing it is important to pay attention to labour costs per production unit (unit labour costs or ULC). Nominal labour costs in TEs are very advantageous in West European comparison. Obviously high wages in Western Europe are linked with high productivity. In ULC figures productivity is taken into consideration. In the table below, there are ULC figures in index form, in which the Austrian level is marked with 100. It is assumed that Austria represents roughly West European average in ULC statistics. Figures are PPP adjusted.

**Table 22. Unit labour costs, 2000 and 2005, PPP adj. (Austria=100)**

	2000	2005	Change 2000–2005, %
Bulgaria	16,93	19,32	14,1
Czech Republic	31,59	42,77	35,4
Estonia	36,47	42,31	16,0
Hungary	27,74	40,96	47,7
Latvia	34,69	31,61	- 8,9
Lithuania	31,63	30,64	- 3,1
Poland	43,81	43,43	- 0,9
Romania	31,31	36,10	15,3
Slovak Republic	25,35	33,41	31,8
Slovenia	66,43	74,36	11,9

Source: WIIW

The richest TE, Slovenia, had in 2005 ULC figure which is only one quarter below the Austrian level. On the other side of the scale is Bulgaria with less than one fifth of the index anchor country. The equivalent figure in Slovakia, Romania, Latvia and Lithuania is about one third.

Thus, Bulgaria is clearly the most advantageous country under review in the light of ULC. Romania is much more expensive location to get work done than Bulgaria when costs per production unit are considered. It is rather surprising that Romania's ULC figure is higher than the equivalent in Slovakia.

Obviously, potential investors in labour-intensive manufacturing watch relative ULC figures carefully. As the above table shows, ULC data in TE-region under review have an increasing tendency. Thus, the labour cost advantage of TE-region in comparison to Western Europe is eroding.

This erosion of ULC attraction in TE-region is not advancing with the same speed everywhere in TEs. In 2000–2005, Latvia's relative figure in ULC calculation diminished by almost 9% indicating that its competitive position in offering cheap labour improved clearly. The equivalent decline in Lithuania was about 3% and in Poland almost 1%. This tendency is naturally advantageous from the point of view of supply-oriented investors active in labour-intensive branches.

The clearly highest growth in relative ULC development in 2000–2005 has taken place in Hungary in which the increase is close to 50%. Hungary has been very successful in attracting FDI in manufacturing. It can be assumed that dynamic inflow of manufacturing FDI has essentially contributed to increasing labour costs, which also affects ULC relative figures. Alongside with Hungary, also Czech Republic and Slovenia have rapidly growing ULC figures (both over 30% in the given period). The former has a high per capita FDI stock, and the latter has had in the early years of the 21<sup>st</sup> century a rapidly increasing FDI inflow. In both cases it can be assumed that ULC growth is linked with increasing FDI influence.

Bulgaria's relative ULC figure grew by just over 14% in 2000–2005, but at the end of that period its ULC level was still far the most advantageous in the above table. In Romania the equivalent growth rate was over 15%, but in 2005 Romania was far more expensive country than Bulgaria in ULC terms. Therefore Romania ought to pay special attention in its labour cost development: neighbouring Bulgaria can provide still very low ULC environment for potential investors, while Romania has essentially higher ULC level.

Both Bulgaria and Romania occupy a piece of Black Sea coast. In these two countries there are mountains suitable for winter sports. Thus, preconditions for mass tourism are given. Obviously, labour market development will in considerable extent depend on success in tourism which is a labour intensive branch.

Price is one of the most decisive factors in present-day mass tourism. Advantageous package deals are sold in massive scale for holidaymakers. Convenient price level in the travel destination is appreciated by average tourists.

It was pointed out above that inflation figures in Bulgaria and Romania differ considerably from each other. The former has more stability than the latter. Also price level differences are remarkable in these two countries. In the table below, average EU price level comprising 25 countries is marked with 100 in 2000 and 2005. Thus, eight countries in the table are included in the average.

**Table 23. Price level in TEs, 2000 and 2005, EU (25)=100**

	2000	2005	Change 2000–2005, %
Bulgaria	31	37	19,4
Czech Republic	46	58	26,1
Estonia	52	59	13,5
Hungary	47	61	29,8
Latvia	50	49	- 2,0
Lithuania	46	49	6,5
Poland	52	55	5,8
Romania	36	48	33,3
Slovak Republic	43	55	27,9
Slovenia	72	73	1,4

Source: WIIW

Bulgaria has the lowest figures in both years under consideration with only 37% of EU average in 2005. Romania is the second cheapest country under review, but its figure (48%) exceeds Bulgarian result with clear margin of over 10%. Latvia and Lithuania are with 49% each close to Romanian level. Not surprisingly, Slovenia with its high living standard in TE-comparison has the highest price level in the table with 73% of EU average.

In the 2000–2005 periods, Romania has the highest growth rate of over 33%. Hungary is not far behind with an equivalent figure of almost 30%. In this context, Bulgaria scores a bit less than 20% increase. Therefore, Bulgaria has gained price competitiveness against Romania in the early years of the new century.

Latvia is the only country in the above table, which has been able to improve its position in relative prices. Its price level in 2000 was just half of EU average, while the 2005 result is moderately better with 49%. Slovenia's figure increased slightly from 72% to 73% (between 2000 and 2005), which in terms of percentage growth is 1,4%. Moderate growth rates can also be observed in Poland and Lithuania. However, the general tendency is that TEs are catching up with the EU average price level with no unified speed. Alongside with Romania and Hungary, Slovakia and Czech Republic have rather high growth rates in the above table of relative prices.



Bulgaria is far the cheapest TE in our selection of countries. This position in the relative price level comparison obviously is an important element on Bulgaria's rapidly decreasing unemployment rate.

## 5 Current Economic Trends

### 5.1 Expansion of Euro-zone

After the historical Eastern enlargement of EU in May 2004 four out of eight TEs entering the Union applied for EMU (European Monetary Union) membership (Estonia, Latvia, Lithuania, and Slovenia). According to EMU rules, there is a compulsory two-year interim period for all potential new euro-zone members. Therefore, decisions concerning euro-zone enlargement were made in the summer 2006.

Two of the four candidate countries, Estonia and Latvia, withdraw their EMU membership application before the final assessment took place. Slovenia's monetary union application was accepted, while Lithuania's euro-area membership was postponed. In this rejection it was stated that Lithuania's overall economic stability is not yet adequate to allow its euro-zone entry.

Thus, Slovenia is the first NMS of EU, which was given green light into EMU. This relatively small national economy with two million people became officially the 13<sup>th</sup> euro-zone member the 1<sup>st</sup> of January, 2007. Slovenia is far the most prosperous NMS with fairly stable economy and well balanced current account. The acceptance of this part of the former Yugoslavian Federation into monetary union was to be expected (see T. Tiusanen – J. Kinnunen: EU's Eastern Enlargement and the Future Expansion of Eurozone. NORDI publication No. 23, Lappeenranta, 2005). The three Baltic states with interest in EMU membership have clearly undervalued currencies combined with rather high current account deficits, and thus, they are not necessarily optimal new EMU members yet, even if overall economic stability in Estonia, Latvia and Lithuania has advanced rather well in the first years of the 21<sup>st</sup> century. Poland, Czech Republic, Slovakia and Hungary have not been in a hurry to join EMU after receiving the EU membership.

Obviously, euro-zone membership in every NMS is such an important issue that it must be supported by a clear majority of population in every potential new EMU member. Therefore, it is unlikely that euro-area membership applications will start flowing in rapidly from NMS-region in the near future. Romania and Bulgaria can hardly deal with the euro issue in several years to come.

## 5.2 Economic Scene in 2006

The European Commission gave on September 26<sup>th</sup>, 2006 the permit to Romania and Bulgaria to join the EU. In this context, the commission imposed a variety of safeguard clauses on the newcomers. It can use financial weapons to endorse its objectives: EU funds will be allocated to the new member states only if they continue their judicial reforms and anti-corruption measures. Both countries are obligated to make six-monthly reports about corruption. EU subsidies will be cut if results in rooting off corruption are unsatisfactory.

One of the most delicate issues in the pan-European integration process is the free movement of labour. In the pre-2004 enlargement period it was decided that “old” EU-members could impose an interim period of seven years before allowing workers to move freely from new to old Union member states. Great Britain, Ireland and Sweden allowed free immigration from NMSs immediately of the Eastern enlargement of EU. Finland imposed a two-year interim period on immigrant workers, which ended in May 2006.

The accession of eight TEs to EU has in 2004–2006 led as many as two million people to head to the West, mainly from Poland, Slovakia, Latvia and Lithuania. Not surprisingly, the destiny of these migrant workers was that part of the “old” EU, which did not impose restrictions in 2004 (Britain, Ireland and Sweden). Other old EU-countries got a part of this labour inflow by allocating work permits (for example, Finland allocated work permits for health care personnel).

Taken together, Romania and Bulgaria have a population of almost 30 million. That is about the same figure as the combined population of Hungary, Czech Republic, Slovakia and Slovenia, but less than Polish population (about 38 million). Living standard in Romania and Bulgaria is clearly below the NMS average. Thus, potentially a high number of Romanians and Bulgarians will move to the West within EU.

There are estimates that about two million Romanians already work abroad, mainly in Mediterranean area of EU. Also in post-communist Bulgaria net emigration has taken place. Therefore, it is unlikely that the latest EU enlargement will cause an extensive labour market reallocation.

The migration of labour is affecting emerging markets. Workers employed abroad normally send back part of their earned income. This flow of money is called workers’ remittances. These are included as part of current account income in the home country of migrant worker

and CA expenditure of the host country point of view. Money transfer takes place via banking system or via other channels. For example, a Polish worker in the UK sends a part of his monthly pay to his family in Poland, or he visits his family occasionally and hands out money in cash. Therefore, remittances cannot be measured in exact terms.

Obviously, transitional economies earn net income in remittances in their current accounts. Thus, remittances may help to combat poverty in labour-exporting countries.

The migration of labour is associated with the phenomenon called “brain drain”. In emerging markets, TEs included, it is often pointed out that educated people emigrate, and thus, cause harm to the local economy. Formation of “human capital” is not free. Country A pays the bill of education, while country B gets the benefit of human capital. Large scale brain drain obviously may hamper the development of country A. However, country A is likely to benefit from remittances send back home by migrant human capital active in country B. Often emerging markets cannot offer appropriate work for highly educated citizens. In this case, human capital has incentive to migrate.

During the post-war boom in Western Europe there was a strong inflow of foreign workers, who were mainly employed in jobs rejected by locals (construction, agriculture, cleaning services etc). Obviously, the big bulk of migrant workers from NMSs belong to this category of low skill labour.

In Poland, it is estimated that the annual remittance by migrant workers is about EUR 4–5 billion or equivalent of monthly export income in foreign trade. About 5% of private consumption is financed by that money earned abroad and remitted back home. Therefore, labour mobility in the biggest NMS is rather important economic advantage presently.

In the pan-European integration process there is one special feature affecting international mobility of labour: undervaluation of currencies in transitional economies. Incomes converted into a common currency (e.g. euro) at market exchange rates (ERs) systematically exaggerate the gap between rich and poor EU-members. As prices and also wages are essentially higher in the rich part than in the poor part of Europe, it is advantageous to migrate from the latter to the former. Workers’ remittances have an essentially higher purchasing power in the receiving country (NMS) than in the country, in which the income is created (in “old” EU-member). It can be maintained that it is advantageous to work in the West (with high wages) and consume in the East (with low prices). An attempt to shed light on this issue via up-to-date statistics is made below.

## 6 Economic Performance of NMS-10 in 2006

### 6.1 Economic Growth

In the framework of Eastern enlargement of EU eight TEs entered the Union. Romania and Bulgaria were accepted with a delay, at the beginning of 2007. However, economic performance of ten new member states can be compared in the light of economic results of 2006.

International living standard comparisons are normally made on the basis of gross domestic product (GDP) figures by converting data into dollars or euros at official exchange rates. Per capita calculation gives an impression of relative wealth of nations in GDP comparison.

It is a well-known fact that rich countries have relatively high price level, while emerging markets have a low one. Differences in price levels are not necessarily reflected in exchange rates. Thus, “real” living standard measurements require purchasing power parity (PPP) adjustments. Figures below gives GDP figures at PPP and per capita.

**Table 24. Gross domestic product per capita at PPP in 2006 (in EUR)**

	<b>2006</b>
Slovenia	20.700
Czech Republic	18.800
Estonia	16.200
Hungary	15.800
Slovakia	14.600
Lithuania	13.700
Latvia	13.100
Poland	12.600
Bulgaria	8.500
Romania	8.500
EU-15 average	26.500
EU-25 average	24.500

Source: WIIW

In the NMS-10 group of countries Slovenia has far the highest living standard, over EUR 20.000 GDP per capita PPP adjusted. That is clearly more than in the poorest “old” EU country, Portugal, with EUR 17.000 equivalent figure. GDP per inhabitant in the “old” EU (15) was in 2006 about EUR 26.500 at PPP.

The lowest equivalent figures in the table above are in Bulgaria and Romania, only EUR 8.500, which is about one third of the EU-15 average level. Thus, Slovenia is about 2,5 times better off than Bulgaria and Romania.

The majority of NMSs in the above table have in 2006 reached living standard level which is at least 50% of the EU-15 average level. Poland is just below this mark.

This comparison reveals probably the most important reason why Bulgaria's and Romania's EU entry was postponed in 2004. The living standard gap was and still is rather severe between Bulgaria and Romania on one side and EU-15 on the other.

In the early period of transition, all TEs experienced a deep slump when the most important issues of systemic change were discussed and also implemented. The second half of the 1990s was still a difficult period of consolidation, but economic growth started to resume. However, growth performance within the region under review has not been uniform during the last ten years. Countrywise differences are actually striking.

**Table 25. Gross domestic product in 2006 (real change in %)**

	<b>Index 1995=100</b>
Czech Republic	136,3
Hungary	156,5
Poland	159,6
Slovak Republic	159,3
Slovenia	154,2
NMS-5	153,6
Bulgaria	129,7
Romania	132,8
Estonia	223,2
Latvia	217,4
Lithuania	190,3
NMS-10	151,8

Source: WIIW

The above table describes the GDP growth scene in NMS-10 between 1995 and 2006 (in the index 1995 is marked with 100). In the light of these index figures, which reflect real economic growth, dynamism in the Baltic states has been superior in the period under review. GDP has more than doubled in Estonia and Latvia. Lithuania is not far away from the achievement of its northern neighbours: real GDP growth exceeded 90% in 1995–2006.

The equivalent average figure in Central Eastern Europe (NMS-5) is 53,6%, and thus, essentially more moderate than in the Baltic states. Poland and Slovenia show both results close to 60%. Hungary is not much behind with 56,5%. Slovenia with the highest living standard in the region shows more dynamic economic growth (54,2%) than the second richest country, Czech Republic (36,3%).

Bulgaria and Romania are at the bottom of the scale in living standard comparison of NMS-10. These two countries have had in 1995–2006 less real economic growth than NMS-5 in average. Bulgaria's index shows just under 30% and Romania's performance slightly over 30% increase in the period under review. These moderate results reflect economic difficulties Bulgaria and Romania were facing in the late 1990s. In both countries transition advanced only hesitantly. Differences between the best performers and the most moderate achievers in the above table are striking.

**Table 26. Employment in 2006, LFS definition (in 1.000 persons)**

	<b>2006</b>	<b>Index 2000=100</b>
Czech Republic	4.810	101,7
Hungary	3.932	102,0
Poland	14.600	100,5
Slovak Republic	2.300	109,4
Slovenia	960	106,5
NMS-5	26.602	101,9
Bulgaria	3.100	110,9
Romania	9.150	87,1
Estonia	646	112,9
Latvia	1.092	116,0
Lithuania	1.502	107,5

\* LFS = Labour Force Survey

Source: WIIW

In all communist countries labour force was used extensively but not necessarily rationally. Therefore, in the early period of transition, market forces reduced employment considerably. Unemployment reached rather high levels in many TEs.

In the first years of the 21<sup>st</sup> century employment has started to increase amid economic growth. However, employment figures are not expanding rapidly.

Development trend of employment is described by index figures (year 2000=100). The highest growth in NMS-10 labour market can be observed in Latvia (16% in 2000–2006). Estonia is not far away with about 13%. These two countries had the best performance in the

GDP growth table. It is not surprising that there is a link between overall economic growth and increasing employment.

Romania's index number in the above table deviates from the generally increasing trend: employment in Romania has decreased between 2000 and 2006 by almost 13%. The picture in Bulgaria is with about 11% increase essentially different from its northern neighbour. Employment in Bulgaria has grown faster than in any CEE in the given period of the above table.

One of the core components of economic growth in TEs is labour productivity in industry (manufacturing). Results achieved in this sphere are excellent between 1995 and 2006.

**Table 27. Labour productivity in industry, 2006**

	<b>Index 1995=100</b>
Czech Republic	220,0
Hungary	302,0
Poland	252,3
Slovak Republic	182,2
Slovenia	185,5
Bulgaria	164,8
Romania	191,4
Estonia	290,4
Latvia	-
Lithuania	207,2

Source: WIIW

Labour productivity has more than tripled in the Hungarian industry since 1995. Estonian figure is relatively close to the Hungarian achievement. Polish productivity has improved 2,5 times. Doubling of the productivity figure can be observed in Czech Republic and Lithuania.

The most modest increase in the productivity trend has taken place in Bulgaria with about 65% enhancement. It can be assumed that one of the most important background factors in this context is the relatively modest investment by international manufacturing companies in Bulgaria. In the Romanian case the index figure is essentially better (over 90% growth) than in Bulgaria. However, Romania's productivity improvement is clearly more moderate than the top performance of the neighbouring Hungary.

Obviously, employment trend and labour productivity development are interlinked. In Romania employment has clearly decreased, while labour productivity has almost doubled, as



shown in two tables above. In Bulgaria more working places have been created, but labour productivity has a rather modest improvement.

## 6.2 Stability and Competitiveness

A country's international competitiveness depends on relative movements of costs or prices. If prices in one country increase more rapidly than in the world in average, it is said that that country's international competitiveness deteriorates. Eroding competitiveness is likely to cause increasing deficits in current account (CA). Serious disequilibrium in CA calls for readjustment of exchange rate. In floating ER system the currency depreciates and in fixed ER regime local currency must be devaluated by the central bank. Modified ER is supposed to bring about relative equilibrium in CA.

Generally speaking, NMS-10 have been rather successful in controlling inflation which was rather high in all TEs in the 1990s.

**Table 28. Inflation and current account equilibrium in 2006 and 2007**

	Consumer prices		Current account	
	Change in % against pervious year		in % of GDP	
	2006	2007*	2006	2007*
Czech Republic	2,5	2,5	-4,4	-4,4
Hungary	3,9	6,3	-6,2	-4,9
Poland	1,0	1,8	-1,9	-2,0
Slovak Republic	4,5	3,0	-7,3	-4,9
Slovenia	2,5	2,6	-2,6	-2,2
NMS-5	2,1	2,8	-3,6	-3,3
Bulgaria	7,3	5,0	-15,8	-13,5
Romania	6,6	6,0	-10,7	-12,7
Estonia	4,4	4,2	-12,9	-10,5
Latvia	6,8	5,8	-15,8	-17,4
Lithuania	3,8	4,6	-8,8	-9,4
NMS-10	3,2	3,5	-5,5	-5,6

\* forecast

Source: WIIW

Poland shows the most moderate inflation figure in the above table in 2006, only 1%. The average inflation in CEE (NMS-5) is with 2,1% very low. Slovakia has the highest figure in this context with 4,5%.

As pointed out above, the Baltic states are going through an extremely dynamic phase in their economies. Amid the boom, there is inflationary pressure which is reflected in the above table. Latvia's inflation rate in 2006 was almost 7%.

Bulgaria has the highest inflation figure of the table with no less than 7,3% in 2006, which is clearly more than one year earlier. Romania is with the equivalent rate of 6,6% not far from Bulgaria's level, but its inflation shows clear deceleration. Thus, the EU newcomers are still rather far away from real price stability.

Current accounts in CEE region were in 2006 relatively well balanced: average deficit was 3,6% of local GDP. Slovakia shows the highest (-7,3%) and Poland the lowest (-1,9%) relative CA deficit. Bulgaria and Latvia have exactly the same annual figure of 15,8%.

Also Estonia with -12,9% and Romania with -10,7% have double-digit CA deficits. Lithuania is not far from the Romanian figure with -8,8%.

In monetary terms, CA deficit in Bulgaria was EUR 3,9 billion in 2006. In the same year foreign direct investment (FDI) inflow in Bulgaria was EUR 4,0 billion. Therefore, Bulgaria's high CA deficit (in relative terms) was conveniently financed by risk capital inflow. FDI figure is somewhat higher than CA deficit. The country must not close the gap in its CA with external credits.

Romanian situation in this context is rather similar: CA deficit in 2006 was accordingly to preliminary figures about EUR 10 billion, while FDI inflow was about EUR 9 billion. Thus, about 90% of the relatively high CA deficit was in 2006 covered by long-term risk capital import.

It can thus be concluded that the two EU newcomers, Bulgaria and Romania, have high CA deficits, but in both cases rather dynamic FDI inflow compensates (in Bulgaria) or almost compensates (Romania) the difference of export income and import expenditure in the framework of current account.

Principally, all EU newcomers have to accept Maastricht Treaty concerning the European monetary union. One NMS, Slovenia, has already entered the euro-zone (January 1<sup>st</sup>, 2007). According to EMU rules, budget deficits are not supposed to exceed 3% of local GDP in any year. Several NMSs have difficulties in reaching this aim.

**Table 29. General government budget balance in 2006 (in % of GDP)**

	<b>2006</b>
Czech Republic	-3,5
Hungary	-9,7
Poland	-3,7
Slovak Republic	-3,4
Slovenia	-1,6
Bulgaria	3,7
Romania	-1,8
Estonia	2,5
Latvia	-1,0
Lithuania	-1,0

Source: WIIW

Fiscal policy seems to have no common denominator within the group of countries under review here. Budget deficits deviate from one NMS to another essentially in the light of 2006 figures. Hungary shows a deficit of almost 10% of GDP (-9,7%), while Bulgaria has a budget surplus of almost 4% of GDP (+3,7). Another surplus can be observed in the above table, Estonia's +2,5%. Moderate budget deficits were 2006 booked in Latvia and Lithuania (1% of GDP each). Also Slovenia's budget is close to equilibrium (-1,6%). Deficits in Czech Republic, Poland and Slovakia exceed the set euro-zone limit of 3% of GDP.

Romania is not as prudent in its fiscal policy as its southern neighbour, Bulgaria. Even though Romania did not reach budget surplus, like Bulgaria, in 2006 its deficit is rather moderate, only 1,8% of GDP. Public sector bookkeeping is thus well under control in the two newest EU-members.

In terms of labour costs Bulgaria and Romania are far the cheapest locations in the EU of 27 countries. According of Ifo-Institute (Munich, Germany), the average compensation of hourly work in industry is EUR 28 in Germany, while the equivalent figure in Romania is EUR 2,30 and EUR 1,60 in Bulgaria (Handelsblatt, 2007). Wage differentials affect investment decisions. Average gross monthly wages (in euros) are compared in NMS-10 in the light of 2006 figures. In Finland this figure was about EUR 2.600.

**Table 30. Average monthly gross wage in 2006 (in EUR)**

	At ER (A)	At PPP (B)	B/A
Czech Republic	713	1.210	1,70
Hungary	646	1.135	1,76
Poland	637	1.138	1,79
Slovak Republic	505	903	1,79
Slovenia	1.210	1.691	1,40
Bulgaria	182	484	2,66
Romania	319	623	1,95
Estonia	594	992	1,67
Latvia	420	802	1,91
Lithuania	434	854	1,97

Source: WIIW

Average monthly gross wage in the richest NMS, Slovenia, is less than half of the equivalent figure in Finland when the Slovenian figure is converted in euros according to the official exchange rate. Slovenians earn in the light of these figures (A) over six times more than Bulgarians which is at the bottom of the earnings scale. In Hungary gross wage is twice as high as in Romania. Earnings in Estonia are clearly higher than in Latvia or Lithuania. Czech Republic and Slovakia were in one and the same federation for decades. Now the Czechs earn over 200 euros more a month than the Slovaks.

As pointed out above, official ERs do not reflect correctly local price levels. All currencies in NMS-10 are undervalued. The level of undervaluation is measured here by dividing purchasing power parity adjusted wage figures (B-figures) by original wage data country by country. The resulting numbers show how much official ERs deviate from the equilibrium rate. A and B figures ought to be identical. In that case the official ER would be in parity (reflect the local price level correctly).

In every national economy wage increases are supposed to go hand in hand with productivity development. If wages grow faster than productivity in a country it is facing so called wage inflation which is harmful for competitiveness. This can be measured with unit labour cost trends. Presently, unit labour cost (ULC) indexes are easily available.

**Table 31. Unit labour costs, ER adjusted**

	<b>Index 2000=100 2006</b>
Czech Republic	149,8
Hungary	147,7
Poland	110,5
Slovak Republic	153,1
Slovenia	111,0
Bulgaria	129,5
Romania	137,7
Estonia	125,6
Latvia	109,0
Lithuania	113,9

Source: WIIW

The above table describes ULC development trend in the early years of the 21<sup>st</sup> century comprising NMS-10. The highest figure of the index can be observed in Slovakia, where ULSs have grown by 53,1% between 2000 and 2006. As pointed out before, Slovakia still has a rather modest wage level in CEE comparison. Neighbouring Hungary and Czech Republic are not far away from Slovakia's ULC growth.

In comparison to these three countries, Poland has improved its position essentially with an equivalent ULC growth of only 10,5%. Slovenia, Latvia and Lithuania also have very moderate growth rates in the above table.

Romania has with 37,7% growth rate in ULC table difficulties beating wage inflation. In comparison, Bulgaria is better off with an equivalent figure of just under 30%. However, these two EU newcomers have improved their relative positions against Slovakia, Czech Republic and Hungary in the light of ULC index (2000–2006). However, Poland as the largest NMS has been able to bring its wage inflation well under control, and thus, is obviously able to attract FDIs in labour intensive branches.

It is a well-known fact that labour cost is not the most important determinant in investment decisions. In FDI flows there are supply-oriented activities (looking for cheap cost factors) and market-seeking operations (seeking reasonable purchasing power in the local market). In post-communist societies foreign investors are mainly in the latter category. Bulgaria and Romania are not in the leading position in per capita FDI figures in the region under review (for details, see T. Tiusanen: *Transitional Economies and International Competitiveness*. NORDI publication No. 31, Lappeenranta, 2006)

The Vienna Institute for International Economic Studies gives FDI figures per capita in 2006 for NMS-10. FDIs are unevenly distributed within the region.

**Table 32. FDI stock per capita, 2006 (in EUR)**

	<b>2006</b>
Czech Republic	5.500
Hungary	5.800
Poland	2.300
Slovak Republic	3.000
Slovenia	3.000
Bulgaria	1.800
Romania	1.400
Estonia	9.700
Latvia	2.600
Lithuania	2.400
NMS-10 average	2.900

Source: WIIW (2007)

Estonia is far the most successful NMS in attracting FDI with a per capita figure of close to EUR 10.000 which is over three times more than the average result in the region under review. Hungary's equivalent figure is close to EUR 6.000, or twice the average amount. Czech Republic is with EUR 5.500 not far away from Hungarian achievement.

As shown above, Estonia is not the most advantageous labour cost country within the Baltic states, and much more expensive than Bulgaria and Romania. Estonia has an excellent position from the point of view of logistics on the Gulf of Finland. In comparison to the Nordic states, Estonia still offers advantageous cost factors. The big bulk of Estonian FDI stock originates from Nordic countries.

Romania has clearly the most modest relative FDI figure in the above table with only EUR 1.400, or about half of the average figure. Obviously, this moderate figure reflects political and economic uncertainty of the 1990s during which Romania hesitated to carry out market reforms. In the 21<sup>st</sup> century FDI inflow has grown essentially in Romania. In March 2007, Nokia announced to make a Greenfield investment of EUR 60 million in Romania in mobile phone manufacturing. Nokia built up a handset production unit in Hungary in the 1990. It was announced that the Hungarian unit has reached its optimal capacity, and thus, a new plant with volume production became necessary (Kauppalehti, 2007). This decision is excellent news for the Romanian economy.

Also Bulgaria hesitated to apply market reforms in the 1990s. Amid economic difficulties IMF entered the Bulgarian economic scene with a rescue package. With this external economic policy-making help Bulgaria has been able to find a new healthy basis for its economy. Investment climate has improved essentially which is visible in the growing FDI inflow in the early years of the new century. However, Bulgaria's FDI stock per capita is the second most modest within NMS-10, only EUR 1.800, far below the average figure. Considering Bulgaria's exceptionally cheap labour costs it can be assumed that FDI inflow will remain dynamic for several years to come.

## 7 Conclusions

In the pre-communist era Bulgaria and Romania were agrarian societies with modest living standard. In the period of central planning both countries went through a shock therapy of industrialization and urbanization. Both societies changed fundamentally in a very short period of time.

Rapidly built industries in Romanian and Bulgarian communist era did not follow market rules, but directives fixed in state planning units. After introduction of market rules in the early years of the 1990s it became clear that many industrial outlets in Bulgaria and Romania are not viable under circumstances of global capitalism. In both countries unemployment started increasing rapidly. Some de-urbanization took place: people started to migrate to the rural economy in order to survive. Large-scale emigration took place. In economic policy-making there were attempts to mitigate the effects transition by subsidising industries and postponing privatisation. Therefore, these two countries were called laggards in the sphere of economic reform which resulted in relegating both Bulgaria and Romania in the list of EU-candidates in the historical Eastern enlargement of EU in 2004.

Obviously, this is an extremely superficial description of economic history in Bulgaria and Romania in the early period of transition. This short report tries to shed light on the very clear turnaround, which has taking place in the economies of Bulgaria and Romania in the turn of the century. Both EU newcomers have very clear dynamism in their respective economies combined with rather well advancing stability. However, inflation rates are clearly higher than in Western Europe. Current accounts show high deficits in Romania and Bulgaria, but strong FDI inflows in both countries help to finance these deficits conveniently.

Bulgaria and Romania are at the bottom of the living standard scale in EU-27. Thus, these two countries cannot afford to have a tight social safety net. Rather massive emigration from post-communist Bulgaria and Romania has taken place. Both countries have still relatively high unemployment rates.

Therefore, it is obvious that there is plenty of social tension in the newest EU member states as income differentials are high. Corruption and organised crime do not vanish with EU membership. Political stability can obviously not be guaranteed under present circumstances. In the near-by Hungary, with essentially higher living standard than in Bulgaria and Romania,



opposition took to the streets in 2006. There were violent clashes between local police force and demonstrators.

Bulgaria has amazingly low nominal wages which are essentially below the Romanian wage level. Bulgarian's currency is extremely strongly undervalued. This fact gives supplementary competitiveness to Bulgarian labour intensive manufacturing branches, and in addition, enhances Bulgaria's price advantage in tourist branch. However, Bulgaria's current account is in relative terms in deeper deficit than Romania's with its less pronounced undervalued currency.

It can be assumed that Romania and Bulgaria will compete with each other in attracting FDIs. In the early years of the 21<sup>st</sup> century, FDI inflow in both countries show rather rapidly increasing trend. This positive phenomenon is highly likely to gain momentum by EU membership.

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