

# EUROPEAN ECONOMY

Occasional Papers 73 | December 2010



Progress towards meeting the economic criteria for accession:  
the assessments of the 2010 Progress Reports and the Opinions

Directorate-General for Economic and Financial Affairs

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KC-AH-10-073-EN-N  
ISBN 978-92-79-18785-8  
doi: 10.2765/10055

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European Commission

Directorate-General for Economic and Financial Affairs

# Progress towards meeting the economic criteria for accession: the assessments of the 2010 Progress Reports and Opinions

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## INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2010 European Commission's Progress Reports and Opinions for candidate and potential candidate countries for EU accession. The Commission prepared Progress Reports for the candidate countries Croatia, the former Yugoslav Republic of Macedonia, Iceland and Turkey as well as for the potential candidate countries Bosnia and Herzegovina and Serbia and for Kosovo <sup>(1)</sup>. Following the two countries application and the Council's request, it also prepared two opinions on Albania and Montenegro. The European Commission adopted the Progress Reports and two Opinions on 9 November 2010.

This introduction explains the methodology underlying these Reports that the Commission has been following since 1997 in order to carry out these assessments.

The purpose of this Occasional Paper is to facilitate the work of those scholars, researchers and analysts of the enlargement process, who are mainly interested in the economic aspects. As such, it represents only a part of the overall progress made by the candidate and potential candidate countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2010 Progress Reports and Opinions.

### **The methodology of the Progress Reports**

In 1993, the Copenhagen European Council identified the economic and political requirements candidate countries will need to fulfil to join the EU. It also concluded that accession could take place as soon as they were capable of fulfilling them.

The criteria are:

- the political criteria - stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;
- the economic criteria - the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- the institutional criteria - the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union, which includes the whole range of policies and measures that constitute the *acquis* of the Union. Candidate countries must adopt, implement and enforce the *acquis*. This requires the administrative capacity to transpose European Community legislation into national legislation, to implement it and to effectively enforce it through appropriate administrative and judicial structures.

The European Commission first assessed progress made by the then candidate countries with respect to these criteria in the 1997 Opinions. Thereafter, the Commission, at the request of the Council, submitted annual Regular Reports (as of 2005 called Progress Reports) to the Council assessing the further progress achieved by each country on their fulfilment. These reports have served as one of the elements for the Council to take decisions on the conduct of negotiations and on the definition of the pre-accession strategy. Since 2005, the potential candidate countries are also assessed according to the same format and methodology.

### **Difference between Progress Report and Opinions**

The 2010 Progress Reports focus on developments during the period October 2009 - September 2010 and seek to assess progress on the two Copenhagen criteria: (1) existence of a functioning market

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<sup>(1)</sup> as defined under UN 1244

economy and (2) capacity to cope with competitive pressure in the EU. The assessments in the two Opinions for Albania and Montenegro are broader in scope as compared to the progress reports, as they contain a full-fledged stock-taking of compliance with the two economic criteria, covering a much broader time frame and a more detailed analysis.

### **The economic sub-criteria**

Regarding the economic criteria, the Commission has examined progress achieved during each year on the basis of a number of sub-criteria applied since 1997. According to these the existence of a functioning market economy requires that:

- macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;
- broad consensus exists about the essentials of economic policy;
- equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;
- significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;
- the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
- the financial sector is sufficiently well developed to channel savings towards productive investment.

The capacity to withstand competitive pressure and market forces within the Union is assessed on the basis of the following factors:

- the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;
- a sufficient amount, at appropriate costs, of human and physical capital, including infrastructure, education and research, and future developments in this field;
- the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.;
- the proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust;
- the degree and the pace of trade integration a country achieves with the Union before enlargement. This applies both to the volume and the nature of goods already traded with Member States.

It is important to note that these conditions do not serve as a simple checklist. First, the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, are pertinent. Second, there is an important time dimension involved. Meeting the economic criteria requires deep and lasting structural reforms that take time to be accomplished. The issue of track record then becomes very relevant. In this context, the concept of track record means the irreversible, sustained



and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.

### **The conclusions of the reports**

The conclusions of the assessments in the economic chapters are provided at the end of each country section in this publication. An important difference in the nature of the Progress Report's conclusions for candidate countries on the one hand and potential candidate countries on the other hand should be noted. Namely, in the case of candidate countries the conclusions summarise the state of compliance with the Copenhagen economic criteria (= level of compliance), while in the case of the potential candidate countries they rather refer to the progress achieved towards compliance. The reason for this is that for candidate countries the Commission has already assessed the level of compliance for the first time in its opinions on the countries' EU membership applications. The two opinions for Albania and Montenegro provide for the first time an assessment of compliance for these two countries. This exercise has not yet been undertaken for the other potential candidate countries, and therefore the assessment and the conclusions can naturally only refer to further progress achieved rather than to level of compliance.



# Assessment of the 2010 Progress Reports and Opinions (Albania and Montenegro)

# 1. CROATIA

In examining the economic developments in Croatia, the Commission's approach was guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

## 1.1 The existence of a functioning market economy

### Economic policy essentials

Croatia is participating in the EU pre-accession fiscal surveillance procedure. The Pre-accession Economic Programme (PEP) for 2010-2012, submitted in January 2010, presented a sufficiently comprehensive and consistent macroeconomic and fiscal framework for economic policies. In April 2010, in response to the continuing recession, the government launched the 'Economic Recovery Programme' consisting of some fiscal measures and comprehensive structural reforms to be implemented over ten years. Broad political consensus on the fundamentals of a market economy was maintained. Overall, consensus on the fundamentals of a market economy was maintained, but efforts need to be intensified to implement the necessary structural reforms.

### Macroeconomic stability

The global financial and economic crisis hit the Croatian economy most severely in the first quarter of 2009, when real GDP dropped 6.7% year-on-year. For 2009 as a whole, GDP declined 5.8% compared to 2.4% annual growth in 2008. GDP-per-capita in current prices rose to 43.2% of the EU-27 average in 2009 from 42.5% a year before. Private consumption fell sharply (from 0.8% growth in 2008 to a drop by 8.5% in 2009) and investments fell even more (from 8.2% growth in 2008 to a drop by 11.8% in 2009). In comparison, the deceleration of public consumption was relatively mild (from 1.9% growth in 2008 to 0.2% in 2009). As economies contracted worldwide, exports from Croatia suffered a sharp contraction (from 1.7% growth in 2008 down to -16.2% in 2009). The decline in imports was even more pronounced (from 3.6% growth in 2008 to a drop by 20.7% in 2009). As a consequence, the contribution of net exports to growth turned positive which offset much of the negative contribution from domestic demand. The decline in economic activity eased in the course of 2009, but output was still contracting in the first half of 2010. Real GDP is estimated to have been 2.5% lower year-on-year in both the first and second quarters of 2010. Similarly to GDP, the downward trend in industrial production started to flatten out in mid-2009 following a 10% decline in the preceding twelve months. In August 2010 industrial production was only 0.7% lower year-on-year. Overall, economic recovery had not yet taken hold by mid-2010 although the rate at which the economy was contracting had receded over the preceding twelve months.

The government launched the Economic Recovery Programme in April 2010 when incoming data showed that the economy was not yet recovering from the recession and fiscal trends were more unfavourable than expected. Apart from some fiscal measures, the programme is a package of structural reforms which seek to address the structural weaknesses of the economy and aim to create an environment encouraging sustainable economic growth. It encompasses basically all existing strategy papers and development documents and provides a new basis for economic policy in the country. The programme includes 131 measures in ten areas to be implemented over ten years. Among other things, it aims at reducing the number of public-sector employees, privatising state-owned enterprises and cutting non-tax revenue, but it also includes a vast number of measures in other fields such as labour market policy, education and science policy, social security, export and investment promotion, government asset management, environmental protection, etc. Overall, the contribution which the Economic Recovery Programme makes to improving the economy's growth potential and international competitiveness will depend on its effective implementation.

The current account deficit narrowed to 5.4% of GDP in 2009 from 9.2% in 2008. This was driven by an improving balance of trade in goods. Since the recession led to a stronger decline in imports than in exports of goods, the trade deficit in goods fell from 22.8% of GDP in 2008 to 16.3% in 2009. The trade surplus for services (mainly tourism and transport) declined from 14.7% of GDP in 2008 to 12.5% in 2009. The deficit in the income balance increased slightly, from 3.3% of GDP in 2008 to 3.9% in 2009. Like in 2008, this mainly reflects higher debt servicing costs in an environment of tighter external financing constraints and lower foreign revenues. In the first half of 2010, the current account deficit continued to narrow as imports of goods and services decreased by 6.6% year-on-year while exports increased by 6.2%. The recent turnaround in exports reflects the recovery in major export markets. In the 12-month period to the end of June 2010 the current account deficit amounted to 3.1% of GDP. Overall, the current account deficit has been narrowing in the recession mainly as a result of lower demand for imported goods, but recently also thanks to rising exports.

Table 1.1:

**Croatia - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	4.2	4.7	5.5	2.4	-5.8	-2.5
Private consumption	Ann. % ch	4.4	3.5	6.2	0.8	-8.5	-3.3
Gross fixed capital formation	Ann. % ch	4.9	10.9	6.5	8.2	-11.8	-13.7
Unemployment	%	N.A.	N.A.	9.6	8.4	9.1	11.8
Employment	Ann. % ch	N.A.	N.A.	1.8	1.3	-1.9	-3.8
Wages	Ann. % ch	4.4	6.2	6.2	7.1	2.2	-1.0
Current account balance	% of GDP	-5.6	-7.0	-7.6	-9.3	-5.4	-3.8
Direct investment (FDI, net)	% of GDP	3.4	6.5	8.0	6.6	2.6	2.7*
CPI	Ann. % ch	3.3	3.2	2.9	6.1	2.4	0.8
Interest rate (3 months)	% p.a.	6.21	4.46	5.66	7.19	8.96	2.24
Stock markets	Index	1,920	2,771	4,673	3,299	1,871	2,081
Exchange rate HRK/EUR	Value	7.39	7.30	7.33	7.22	7.34	7.27
Nominal eff. exchange rate	Index	100.0	98.8	97.2	94.2	96.7	96.7
General government balance	% of GDP	-3.5	-3.0	-2.5	-1.4	-4.1	N.A.
General government debt	% of GDP	38.3	35.5	32.9	28.9	35.3	N.A.

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Net capital inflows receded in 2009 and the first half of 2010 as a corollary of the declining current account deficit. Excluding changes in international reserves, they fell from 11.7% of GDP in 2008 to 9.2% in 2009. In the 12-month period to the end of June 2010 they amounted to 3.7% of GDP. This decline is to a large extent accounted for by a sharp fall in inward foreign direct investments (FDI), but borrowing abroad has also decreased, particularly in the first half of 2010. Inward FDI almost halved in absolute terms and, as a share of GDP, fell from 8.8% in 2008 to 4.7% in 2009. Outward FDI remained stable at 2.0% of GDP over the same period. While net FDI flows covered 74% of the current account deficit in 2008, this figure fell to 49% in 2009. The structure of FDI remained unchanged, i.e. dominated by equity investments, including some recapitalisations in the banking sector. In the first half of 2010, FDI inflows declined by 32.0% year-on-year. The total stock of FDI stood at €24.4 billion (around 54% of GDP) at the end of March 2010. Overall, in the context of a declining current account deficit, sufficient external financing was secured despite lower net capital inflows.

The heavy external debt burden continued to increase in 2009. The stock of external debt went up by €4 billion to €43.1 billion (excluding round-tripping transactions), equivalent to 95.0% of GDP compared with 82.6% at the end of 2008. The rise in external indebtedness was mainly driven by corporate borrowing, but the central government also increased its foreign debt by around €1 billion. The fact that the non-tradable sector accounts for around 40% of gross foreign debt remains a cause for particular concern. Overall, the high and growing level of external debt and the relatively large exposure of the non-tradable sector to currency risks remain key external vulnerabilities of the Croatian economy.

The average annual unemployment rate was 9.1% in 2009. The quarterly data from the labour force survey show that the unemployment rate started rising in the last quarter of 2009 and reached 12.4% in the second quarter of 2010, up from 8.7% in the third quarter of 2009. Data on the number of people registered as unemployed confirm this change of trend. This measure of the unemployment rate rose from 13.2% in 2008 to 14.9% in 2009 and stood at 16.4% in August 2010. Total employment was 4.8% lower year-on-year in the second quarter of 2010 according to the labour force survey. The Croatian labour market continues to suffer from major structural weaknesses, such as low employment and participation rates along with high rates of youth and long-term unemployment. The employment and participation rates declined to 56.6% and 62.4%, respectively, while the youth unemployment rate increased to 25.1% in 2009. The effective retirement age remained low and significant labour supply disincentives persisted, including generous early retirement rules and the predominance of categorical social welfare benefits. Employment has been negatively affected by Croatia's limited progress on improving incentives structures and the combination of flexibility and security in the labour market. As a result, labour turnover remained low, suggesting limited re-allocation of labour resources. Wage movements reflected the weakening of the labour market. Average gross wages still increased by 3.0% from 2008 to 2009, but then recorded a year-on-year decline of 0.6% in the first half of 2010. In real terms, average gross wages increased by 0.6% in 2009, but fell by 1.3% year-on-year in the first half of 2010. Overall, the labour market situation deteriorated significantly as a result of the recession. Major structural weaknesses persist in the labour market.

Monetary policy continued to be oriented towards a tightly managed kuna/euro exchange rate with little variability, but without a formal peg to the euro. This monetary policy framework anchors inflation expectations and reduces exchange rate-related credit risks in a highly euroised economy. Under the recessionary conditions of 2009, with intermittent upward pressure on the kuna, it allowed a slight easing of monetary policy. The central bank expanded domestic kuna liquidity in line with available foreign exchange resources. It released significant foreign exchange liquidity to the domestic banking system by removing the 12% annual credit growth limit and by relaxing reserve and liquidity requirements. The central bank intervened in the foreign exchange market on six occasions between October 2009 and July 2010 to counter appreciation pressures on the kuna, purchasing a total of around €869 million. Overall foreign exchange operations in 2009 increased gross international reserves by 13.8% to €10.4 billion at the end of 2009. Their rise continued in 2010, reaching €11.4 billion at the end of August which is equivalent to around seven months of imports of goods and services. The average daily exchange rate fluctuated within a relatively narrow range between 7.19 and 7.33 kuna per euro. Overall, the central bank has adopted an accommodative monetary policy stance during the recession, while maintaining exchange rate and financial stability.

The growth rate for domestic monetary and credit aggregates fell sharply in 2009. Growth of domestic credit to the private sector decreased from 10.5% in 2008 to -0.6% in 2009. Lending to private households was significantly lower (-2.9%) whereas lending to the corporate sector still increased (2.0%). These diverging trends continued in the first seven months of 2010. While loans to households remained stagnant, corporate loans showed a mild recovery with an annual increase of 5.4% at the end of July. Almost half of the recent increase in corporate loans was related to the government's programme to stimulate corporate financing through the State Development Bank (HBOR). Lending to the government sector has increased markedly. Overall, credit growth to private households has fallen to close to zero, lending to the corporate sector has shown signs of recovery, and the structure of credit has continued shifting towards government financing.

Average annual inflation fell sharply from 5.8% in 2008 to 2.2% in 2009. The disinflationary process was primarily driven by the growing slack in the use of resources transmitted to price- and wage-setting. Additional reasons were the collapse in oil prices between mid-2008 and the second quarter of 2009 and the worldwide decline in food prices. The slowdown in inflation in 2009 was mitigated by significant increases in the regulated prices for gas, tobacco products and medical services. Core inflation, as defined by the central bank, declined from 5.7% in 2008 to 2.8% in 2009.

Notwithstanding a rebound in energy prices, disinflation has continued in 2010. The July readings of overall consumer price inflation and core inflation stood at, respectively, 1.0% and -1.4% year-on-year. Overall, inflation has practically vanished in the context of the prolonged recession.

Public finances continued to be under pressure from weaker-than-expected economic activity in the final months of 2009 even after three budget revisions earlier in the year. Although current spending was cut at short notice, the target for the 2009 general government fiscal deficit was missed by a wide margin (-4.1% of GDP compared with -3.4% in the third budget revision). Revenues continued to fall short of government projections in the first half of 2010 as the recession dragged on for longer than expected, forcing the government to increase its borrowing programme. The 2010 budget adopted in December 2009 had projected a general government fiscal deficit equivalent to 3.3% of GDP, but it soon became clear that the deficit would rise rather than fall compared with 2009. In addition to the prolonged recession, a number of fiscal measures adopted in the first half of 2010 were projected to have the net effect of widening the deficit somewhat. On the revenue side, the 2% special crisis levy was lifted and tax rates were lowered, partly offset by the abolishment of numerous tax exemptions. On the expenditure side, several benefits were reduced (including privileged pensions and supplementary health insurance benefits paid from the budget). In view of the worsening fiscal outlook, a budget revision was adopted at the end of August, this time based on the assumption of a 1.6% decline in real GDP in 2010. The revised budget lowered projected revenues of general government by 4.5% of GDP and increased expenditures by 0.3% of GDP compared with the original budget. The projection for the general government deficit was raised by 1.9 percentage points to 5.2% of GDP. As part of the budget revision, excise taxes on tobacco and petrol were raised, increasing annual revenues by 0.15% of GDP. Furthermore, it was decided that total budget expenditures in 2011 and 2012 would not exceed the revised expenditure level for 2010. According to the latest data submitted by Croatia in September 2010, the stock of general government consolidated gross debt increased significantly from 29.3% of GDP at the end of 2008 to 35.4% at the end of 2009 and 37.0% in mid-2010. When outstanding state guarantees and the debt of the State Development Bank (HBOR) are included, the level of public debt amounted to 53.5% of GDP in mid-2010. Overall, the authorities made limited efforts to contain the continuing rise of the fiscal deficit. Weaknesses remain in budget planning, posing a risk that budget outcomes will continue to diverge significantly from budget projections. Ensuring medium-term fiscal sustainability remains a key challenge.

Limited progress has been made on rationalisation of public spending, which is a key Accession Partnership priority. Some further health reform measures have been adopted as a major step towards addressing the sector's financial difficulties. These include streamlining the hospital network and the supplementary health insurance system. No specific action has been taken so far to achieve better targeting of social support, but this is now planned under the Economic Recovery Programme. Some mandatory benefits have been reduced, but they still account for the large majority of social spending. A first step has been made on reforming the pension system with the adoption of a law on privileged pension reduction. Overall, apart from some key measures to reform health care, little progress has been made towards increasing the efficiency of public spending.

Implementation of a comprehensive treasury reform strategy has continued with a view to further improving expenditure management and budget control systems following the entry into force of the 2008 Budget Law which has improved the legal basis for strategic and multi-annual budget planning. Progress continued on enhancing the institutional and analytical capacity for setting up medium-term macroeconomic and fiscal frameworks. However, further progress on streamlining procedures is needed to link the policy priorities set to the budget planning process more effectively. The fiscal notification was submitted in April 2010, but little progress was made towards bringing this reporting more in line with ESA95 standards. Fiscal transparency remains a concern, due to the non-inclusion in the general government accounts of some quasi-fiscal operations (the State Development Bank and the Motorway Company) and a large number of municipalities. Overall, analytical and institutional

capacity on public finance has continued to improve, but strategy-based budget planning needs to be strengthened further.

Overall, the short-term macroeconomic policy response has, by and large, been appropriate to address the domestic consequences of the global economic and financial crisis. Within the constraints ensuing from the high degree of euroisation, monetary policy succeeded in preserving exchange rate and financial stability while alleviating liquidity pressures. Fiscal policy has, to a limited extent, tried to contain the negative budgetary consequences of the recession. To achieve medium-term fiscal sustainability, key challenges remaining are to improve the budgetary process and discipline and to enhance the efficiency of public spending.

### **Interplay of market forces**

Privatisation of assets held under the State Privatisation Fund made only limited progress. As regards the shipbuilding sector which generates revenues equivalent to about 2.5% of GDP, a restructuring and privatisation is ongoing (see also Chapter 8). The only significant privatisation executed in the reporting period was the sale of a food-processing enterprise. A number of calls for tenders have not been successful, partly due to lack of interest among potential investors and, in some cases, rather unrealistic sale conditions. The portfolio of the Privatisation Fund still comprised 768 companies, with the state keeping a majority holding in 79 of them. The overall size of the Fund's portfolio has remained virtually unchanged. Since the remaining holdings of the Fund consist predominantly of highly indebted and loss-making companies, finding strategic partners is a lengthy process, requiring several stages prior to declaring bankruptcy or liquidation. However, adoption of the Economic Recovery Programme and the transfer of all the state's minority share-holdings (below 25%) to the Privatisation Fund should help to speed up the privatisation process. Also, some initial steps have been taken to restructure the Fund into a new Property Management Agency that would combine and ensure better management of all state property. The private sector's share of employment has remained at around 70% and its share of GDP is also estimated at around 70%. Overall, very limited progress has been made towards reducing the large role of the state in the economy.

### **Market entry and exit**

Company registration procedures were further simplified in November 2009. Nevertheless, preliminary data indicate that the number of newly registered companies declined by 14% in 2009 year-on-year and the number of active businesses remained practically unchanged compared with a 12% growth rate in the preceding year. The regulatory impact assessment authority came into operation in late 2009 and a set of measures to improve the investment climate have been adopted as part of the Economic Recovery Programme. The investment climate, however, still suffers from difficulties in obtaining necessary licences, building permits and other authorisations. In addition, a large number of para-fiscal taxes at national and local levels still burden entrepreneurs although some of them have been reduced in tourism, forestry and the cultural heritage sector. The business environment also continues to suffer from inefficiencies in the public administration. Foreign direct investment is held back by the various shortcomings in the business environment. Overall, further progress has been made on simplifying company registration, but the investment climate continued to suffer from a heavy regulatory burden and numerous para-fiscal taxes. Improving the business environment remains a key Accession Partnership priority.

### **Legal system**

Further progress was made in speeding up court procedures. However, the length of proceedings before the courts remains generally excessive and problems persist with enforcement of court decisions. The weaknesses of the judicial system continue to undermine effective enforcement of creditor and property rights. Land registration has improved, but remains incomplete in parts of the



country. Investors still suffer from lengthy procedures to register property. Corruption is being tackled more vigorously but still affects the business environment. Overall, the judicial system has been improved although the enforcement of property rights is still weak. The business environment is also affected negatively by other remaining inefficiencies.

### Financial sector development

The financial sector continued to be dominated by banks which held around 77% of total assets of financial intermediaries in 2009. The banking sector is almost completely privatised with 91% foreign ownership in terms of net assets. Out of 32 banks (down from 33 in the previous year following the merger between two banks), two remained state-owned. The market share of the four largest banks remained at around 65% by March 2010. Market concentration has remained at a moderate level and has generally not hindered market competition.

Banking sector assets continued to grow, but at a slower pace, and the structure of assets changed considerably. This is due to a reduction of banks' foreign assets and reserves with the central bank, as a result of regulatory changes. Lending to the private sector slowed, particularly to households, reflecting lower demand and higher risk awareness on the part of banks in the context of the global financial crisis. However, lending to the government sector increased strongly, more than offsetting the overall decline in lending to the private sector and resulting in 2.3% growth in total bank lending over 2009. In terms of GDP, total bank lending rose from 72.1% at the end of 2008 to 75.8% at the end of 2009. In the first seven months of 2010, total bank lending increased by 4.7% although lending to households remained almost stagnant. Overall, the largely private and foreign-owned banking sector remained the dominant part of the financial sector as a whole, with a moderate degree of market concentration.

The banking sector remained well capitalised as a result of previous prudential and supervisory measures to address potential macro-financial vulnerabilities. The capital adequacy ratio increased from 15.9% in mid-2009 to 19.2% in mid-2010. This was partly caused by the adoption of Basel II standards regarding the calculation of the capital adequacy ratio and partly a consequence of the relative shift in lending from the private to the government sector. The profitability of banks declined in parallel with business conditions and pre-tax income was 20% lower year-on-year in the first half of 2010. The share of non-performing loans increased significantly from 4.9% at the end of 2008 to 7.8% by the end of 2009 and 9.5% in mid-2010. At the same time, the banking system continued to face considerable interest- and currency-related credit risks as the majority of loans are based on variable interest rates and denominated in (or indexed to) foreign currencies, predominantly the euro. Developments affecting the stability of the financial sector have been kept under close watch by the central bank, which enhanced its institutional and analytical capacity to produce assessments of the stability of the sector. Overall, the banking sector remained relatively resilient to shocks, but significant risks are posed by largely un-hedged liabilities of the non-financial private sector.

The share of non-banking financial sector assets in total financial sector assets declined from 26% at the end of 2008 to 23% at the end of 2009. This was largely due to the poor performance of investment funds which suffered significant share price falls and cash withdrawals in the context of the global financial crisis. At the same time, leasing companies and the insurance sector gained in both absolute and relative terms. After losing almost 70% in 2008, the stock market index recovered by 16% in 2009. Over the first nine months of 2010 the index has declined by about 4%. Market capitalisation of shares listed on the Zagreb stock exchange totalled 53% of GDP at the end of 2009 compared with over 100% before the financial crisis. Market capitalisation of all listed bonds rose from 10% of GDP to 11% in the course of 2009, as a result of a slight increase in bond prices and some new bond issues. Overall, notwithstanding the growth of some market segments, financial intermediation by the non-banking sector remained relatively modest. The stock market has only partially recovered from the sharp losses during the financial crisis.

## **1.2. The capacity to cope with competitive pressure and market forces within the Union**

### **Existence of a functioning market economy**

The policy response to the global economic and financial crisis has, by and large, been appropriate. A prudent response by the monetary authorities and efforts, albeit limited, to contain the fiscal deficit have helped to anchor the expectations of economic operators and supported market mechanisms. The country has a functioning market economy.

### **Endowment with human and physical capital**

Educational reforms have continued under the 2005-2010 development plan for the education system. Further steps were taken to improve the quality of education at all levels, including in the form of training of teachers. Additional efforts have been made to develop a national qualifications framework. Higher education has been further aligned with the principles of the Bologna process, although tertiary education generally continues to suffer from inefficiencies, poor governance and lack of funding. Further progress has been made towards developing a knowledge-based economy. The ICT infrastructure is relatively well developed, with high internet and broadband penetration rates.

The government continued to implement labour market policies on the basis of the National Employment Promotion Plan. Measures include training and employment subsidies for young people without work experience, the long-term unemployed, older persons and vulnerable groups. On top of this, a set of measures were adopted under the Economic Recovery Programme to make the labour market more dynamic. Some of these have already been implemented by May/June 2010, for example the introduction of a system of volunteering, apprenticeships, work practice and internships. However, structural problems persisted, as indicated by the high rate of youth unemployment and low employment and participation rates. Overall, in spite of various policy measures, structural weaknesses in the labour market remain major challenges.

Investment declined sharply in 2009 and in the first half of 2010, mainly due to a slowdown of construction activity. As a share of GDP, investment fell from 27.6% in 2008 to 24.7% in 2009. The decline in investments in processing and manufacturing industry has harmed the prospects for faster technological change, a more diversified production structure and higher export potential. Public investments slowed down a little, but remained significant, in particular in the motorway network. The largest share of cumulative FDI inflows is accounted for by the financial sector (37%), followed by manufacturing (25%) and wholesale and retail trade (16%). The long-standing shortage of greenfield FDI remains. Overall, investment declined in the context of the recession and continued to concentrate on transport infrastructure and the services sector.

### **Sector and enterprise structure**

Restructuring the shipyards in difficulty is a key Accession Partnership priority. The tendering procedure for the yards was completed in May 2010. Implementation of the National Restructuring Programme (NRP) for the steel sector has been disrupted by the global economic crisis. Therefore, the NRP, as well as individual business plans, will have to be revised (see Chapter 8). Very limited progress has been made with restructuring the large loss-making railway company and privatising subsidiaries. Only two out of eight subsidiaries were privatised and one underwent bankruptcy procedures. The railways continue to receive high levels of budget support. Overall, although the tendering of the shipyards for privatisation has proceeded, considerable further work will have to be done by the state to restructure or liquidate the yards that are no longer viable. Sustained efforts are required to complete the restructuring of the steel industry and railways to ensure their long-term viability and competitiveness.

The telecommunications industry was further liberalised. The Croatian Telecommunications Agency continued activities aimed at stimulating competition by improving market access to new service-providers. This led to further price reductions and to a larger choice of tariff packages for customers. Liberalisation of the energy sector continued gradually and network rules for gas transport and distribution have been enacted. However, gas and electricity markets remain dominated by single suppliers, preventing effective competition. The restructuring of the large electricity company has not advanced. Overall, despite further legal and regulatory adjustments, competition in network industries remains constrained by dominant incumbent suppliers.

The already large services sector increased its share of total gross value added from 65.0% in 2008 to 66.0% in 2009, the share of industry fell from 20.2% to 19.1%, the share of construction decreased slightly from 8.3% to 8.0%, and the share of agriculture, forestry and fishing increased from 6.4% to 6.7%. While the share of construction in total employment remained practically unchanged at just below 9%, the share of industry declined from 21.6% to 20%. Agriculture's share of employment increased slightly from 13.6% to 14.1%.

In 2009, small and medium-sized enterprises (SME) accounted for around 40% of the corporate sector's total assets, 66% of total employment and 46% of total investment. SMEs generated 55.7% of GDP and more than 42% of total exports. Except for investment where the share declined from 65%, those indicators remained virtually unchanged compared with the previous year. In order to support the SME sector, the government adopted an operational plan for 2010 and a set of measures under the Economic Recovery Programme. The State Development Bank (HBOR) was further strengthened financially to increase lending to SMEs on more favourable terms. Still, the sector continued to suffer from a cumbersome regulatory framework and inefficiencies in public administration. Access to longer-term financing remained difficult, particularly for newly established businesses. Overall, while the SME sector continued to benefit from significant government support, its share in the overall economy has not increased.

### **State influence on competitiveness**

The role of the Competition Agency in monitoring and controlling state aid has been strengthened. Administrative capacity and enforcement of competition policy continue to improve. Public subsidies remained unchanged at the high level of 2.4% of GDP in 2009 and a large share still went to loss-making companies. Although horizontal aid has increased relative to sector-specific aid, it still accounts for only a small share of total subsidies. Overall, state intervention in the enterprise sector remained substantial.

### **Economic integration with the EU**

Croatia is an open economy with total trade in goods and services accounting for around 75% of GDP in 2009. This ratio declined significantly from 92% in 2008 due to the worldwide contraction of trade. Apart from exports of machinery and transport equipment (mainly ships), tourism remained the biggest source of export revenue, generating 14% of GDP in 2009. The EU has continued to be Croatia's largest trading partner. Its share of total Croatian exports and imports remained at around 60% and 63% respectively. CEFTA countries accounted for 10.5% of all Croatian trade in 2009, but this share decreased to 9.7% in the first seven months of 2010. Over this period, CEFTA countries generated 5% of total imports into Croatia and 18% of all exports from Croatia. Around 95% of FDI inflows originate from EU Member States. Overall, integration with the EU in the areas of trade and investment remained high.

The average nominal effective exchange rate for the kuna was 2.7% lower in 2009 than in 2008 mainly due to a significant fall in the average exchange rate between the kuna and the US dollar. However, since inflation was higher in Croatia than among its main trading partners, the nominal

depreciation was not turned into a noticeable, if any, improvement in the international competitiveness of the Croatian economy. In annual average terms, the kuna's real effective exchange rate was 0.5% lower year-on-year when using consumer prices as deflator and 2.8% higher when using producer prices. Unit labour costs suggest a slight depreciation of the kuna in real effective terms in 2009. Overall, standard indicators point to no significant change in Croatia's international price competitiveness.

### **1.3. Conclusions**

The economy of Croatia has been severely affected by the global economic and financial crisis. The country fell into recession in the first quarter of 2009 and there were no clear signs of a recovery by mid-2010. Unemployment, public deficit and debt have increased significantly. External indebtedness rose further and remains a key vulnerability of the economy. Monetary stability was preserved by the policies of the central bank and the financial sector weathered the crisis relatively well.

As regards the economic criteria, Croatia is a functioning market economy. Croatia should be able to cope with competitive pressures and market forces within the Union, provided that it implements its comprehensive reform programme with determination in order to reduce structural weaknesses.

Broad political consensus on the fundamentals of a market economy was maintained. The Economic Recovery Programme has given economic policy a medium-term orientation. The programme's benefit for growth and international competitiveness depends on its effective implementation. Given the existing constraints, macroeconomic policy has, by and large, been appropriate to address the consequences of the global economic and financial crisis. Monetary policy succeeded to preserve exchange rate and financial stability while alleviating liquidity pressures. The current account deficit narrowed as a consequence of the recession and inflationary pressures subsided further. The banking sector remained resilient to shocks.

However, structural reforms generally advanced at a very slow pace, not least with respect to privatisation and the restructuring of loss-making enterprises. The labour market remained highly rigid, with low employment and participation rates which declined further during the recession. In the fiscal area, the authorities made limited efforts to contain the rising deficit and to increase the efficiency of public spending. Social transfer payments remained high and not well-targeted and a large number of state-owned enterprises continued to receive State support through direct and indirect subsidies and guarantees. For achieving medium-term fiscal sustainability, it remains a key challenge to improve the budgetary process and discipline and to enhance the efficiency of public spending. The investment climate continued to suffer from a heavy regulatory burden and numerous para-fiscal taxes.

## 2. ICELAND

In examining economic developments in Iceland, the Commission's approach has been guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

Following the collapse of the country's financial sector in October 2008, economic policy has been oriented towards stabilising the economy. Economic policy is formulated by the newly established Ministry of Economic Affairs and the Ministry of Finance in cooperation with other relevant ministries. The current IMF stand-by programme provides an important anchor for economic stabilisation. It has been implemented successfully so far, with some temporary delays. Broad political consensus on the key essentials of a market economy and the preservation of the welfare state remains. However, the previous political cohesiveness has been stretched by the negative effects of the crisis and the polarising domestic debates over causes of and responsibilities for the crisis. The country has been included in the EU Pre-Accession Fiscal Surveillance procedure, and has already received an invitation by the Commission to submit its first Pre-Accession Economic Programme with a medium-term macroeconomic and fiscal programme, by January 2011.

#### Macroeconomic stability

Following the banking sector crisis in October 2008, economic activity and domestic demand started to drop sharply. The decline of annual economic growth rates accelerated during 2009, leading to a marked fall in real GDP by 6.8% for the year as a whole. The recession was strongly driven by a 50% drop in total investments, particularly pronounced in construction and the services sector, and a 16% decline in private consumption. As a result, domestic demand made a large negative contribution to GDP growth. Shrinking imports as well as export growth turned the contribution of net exports positive. The economy contracted further in the first half of 2010, when real GDP fell by 7.3% year-on-year. Moreover, the quarterly growth rate (in seasonally adjusted terms) deteriorated from -1.2% in the first quarter to -3.1% in the second quarter, also indicating that the recession has not yet bottomed out. The rebound in private consumption, which started growing in the second half of 2009, turned out to be temporary as growth rates again turned negative in the first half of 2010. The speed of contraction of investment slowed somewhat but prospects for a rebound in investment growth remain uncertain, partly owing to delays in energy-intensive projects, reflecting, inter alia, financing constraints in the corporate sector. In the third quarter of 2010, consumer sentiment and expectations have somewhat improved, but high frequency indicators do not yet suggest a growth recovery. As a result of the crisis, average per capita income (in Purchasing Power Standards) fell to 120% of the EU-27 average in 2009. Overall, the crisis led to a deep and prolonged recession and economic activity has not yet started to pick up.

External deficits have shrunk markedly following the recession. The sharp contraction in domestic demand and depreciation of the exchange rate (around 50% during the crisis) contributed to a substantial improvement in the balance of goods and services, which recorded a surplus of around 9% of GDP in 2009, compared to deficit of 3% a year before. The current account deficit fell from more than 20% of GDP in 2008 to 2.2% last year, also helped by a much lower deficit in the income balance. Recent developments suggest further improvements in external trade. In the first half of 2010, thanks to a good export performance, the surplus in trade of goods and services increased to around 10% of GDP, compared to around 7.5% in the first half of the previous year. However, the current account deteriorated and its deficit increased to 3.5% (compared to a surplus of 2.8% in the

first half of 2009), mainly due to a three-fold increase in the deficit of the income balance. More recent merchandise trade data suggest some deterioration as exports dropped in August by 5% year-on-year. Overall, external deficits have shrunk and the merchandise trade surplus has continued to strengthen.

*Table 2.1:*  
**Iceland - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	7.5	4.6	6.0	1.0	-6.8	-7.4
Private consumption	Ann. % ch	12.7	3.6	5.6	-7.9	-16.0	-1.1
Gross fixed capital formation	Ann. % ch	35.7	22.4	-11.1	-20.9	-50.9	-12.0
Unemployment	%	2.6	2.9	2.3	3.0	7.2	8.4
Employment	Ann. % ch	3.3	5.1	4.5	0.7	-6.1	0.1
Wages	Ann. % ch	6.8	9.5	9.0	8.1	3.9	4.0
Current account balance	% of GDP	-16.1	-23.8	-16.3	-22.1	-2.2	-3.5
Direct investment (FDI, net)	% of GDP	-24.6	-10.2	-16.5	30.5	-17.6	-19.0
CPI, average	Ann. % ch	4.0	6.7	5.1	12.7	12.0	7.3
Interest rate (3 months)	% p.a.	9.4	12.4	14.3	15.8	11.3	7.9
Stock markets	Index	3,991	5,494	7,017	3,510	465	547
Exchange rate ISK/EUR	Value	78.17	87.84	87.66	127.58	172.15	169.37
Nominal eff. exchange rate	Index	100.0	89.5	90.9	65.9	47.6	46.8
General government balance	% of GDP	4.9	6.3	5.4	-13.5	-9.9	-3.5
General government debt	% of GDP	25.4	30.1	28.6	70.6	106.4	-

Sources: Thomson Reuters/Ecowin, Eurostat

Total net capital inflows in 2009 were larger than the amounts needed to finance the current account deficit. As a result, gross official foreign exchange reserves held at the central bank increased by an amount equivalent to 1.7% of GDP. In 2010, reserves continued to increase and stood at around 38% of GDP in mid-2010, compared to 25% a year before. The increase in reserves partly reflects official financing provided in the context of the IMF programme and through bilateral loans, totalling around 6% of GDP. The very high level of external debt continues to represent a key challenge to the Icelandic economy. Estimates of the size of the country's external debt have been rapidly changing following the financial crisis, due to uncertainties about the impact of the collapsed banks on the level of foreign debt. Excluding the latter, the stock of gross foreign debt is now estimated at around 230% of GDP at mid-2010, compared to a pre-crisis level (end-2007) of around 570% of GDP. The private sector accounts for two thirds of the external debt stock (the private non-financial sector for about 55%). Overall, foreign exchange reserves strengthened, partly backed by official external financing, but foreign indebtedness remains considerable.

The crisis seriously affected developments on the labour market as unemployment increased markedly and the number of employed dropped compared to pre-crisis levels. Those effects were still being felt through 2010, and adjustments in the over-leveraged construction sector have particularly contributed to unemployment. Elements of flexibility seem to have provided a degree of cushion, such as a reduced level of hours worked, increased part-time work and real wage flexibility. Nonetheless, according to the Labour Force Survey, the unemployment rate rose to 9% in the second quarter, from 7.7% in the first quarter, but was lower than the 9.4% in the corresponding period of the previous year. Total employment levels increased by 1.2% year-on-year in the second quarter, following a drop of 1% in the first quarter, bringing the average employment in the first half of the year to the same level as in the corresponding period of the previous year. In the first half of 2010, nominal gross wages and salaries increased by around 4%, similar to the wage growth rate in 2009. This translates into a real wage decline of 3% during the same period. However, since mid-2010, the growth of nominal wages accelerated to 6% in both July and August, which led to positive real wage growth by around 1.2%. Overall, the recession has led to a significant decline in employment and increase in unemployment.

Regarding monetary policy developments, increased stability of the exchange rate enabled the Central Bank to continue to gradually ease the monetary policy stance. In 2010, the key policy rate (i.e. the seven days collateralised lending rate) was cut several times to reach 6.25% by September. This compares with a peak rate of 18% at end-2008 in the aftermath of the banking sector collapse. The Central Bank has followed and intends to continue a strategy of exchange rate stabilisation supported for the time being by a regime of capital controls that have been reinforced since last November. The underlying trade surplus, improved terms of trade, and the declining risk premium have supported the appreciation of the Icelandic króna by around 15% vis-à-vis the euro during the first eight months of the year. This enabled the Central Bank to cease intervening on the foreign exchange market to support the króna since December 2009. Indeed, the Central Bank began foreign exchange purchases in August to bolster non-borrowed reserves. Under the current policy framework, exchange rate risks continue to appear rather limited over the short term. However, looking forward, the temporary capital account restrictions are to be gradually lifted in due time as the economy stabilises further; nevertheless, this could still entail potential risks. Annual inflation gradually came down to 6.6% in January 2010, from its peak of 18.6% in January 2009. It temporarily accelerated slightly to 8.5% in March on the back of increases in energy prices, indirect taxes and government fees, but continued to decelerate to 3.7% in September. Inflation expectations have stabilised and inflation risks appear relatively balanced. Low domestic demand and falling house prices would lower the inflation rate, while further tax -and administrative price increases and wage pressures in the tradable sectors may exert some upward movements. A weaker króna and therefore higher import prices would immediately be felt through higher inflation as imported goods account for one third of the price index. Overall, exchange rate stability and lower inflation have allowed some flexibility to reduce interest rates. However, capital controls are still in place and their gradual lifting, albeit necessary, represents a significant challenge.

Public finances suffered a marked deterioration in the wake of the October 2008 crisis with the general government deficit increasing to 9.9% of GDP in 2009, prompting the government to launch a series of fiscal adjustment measures in the context of the IMF programme which continued into 2010. The 2010 budget foresees a reduction of the general government deficit by three and a half percentage points to 5.6% of GDP. To that extent, the budget comprises a series of additional fiscal measures on the revenue side, such as tax increases (VAT, excise duties, energy tax) and increases in social security contributions, as well as cuts in spending. Budget implementation in the first half of 2010 showed an increase in general government revenues by close to 10% year-on-year, supported by higher VAT rates, excises and energy taxes as well as marked increase in social contributions which compensated for shortfalls in personal income tax collection. Overall, budget revenue execution was above plan, but some downside risks remain in the second half of the year due to a slower than expected economic recovery. The increase in total spending was contained at 4%, helped by a reduction in the wage bill ( 2%), cuts in social spending ( 7%) and much lower capital investments ( 27%). Some planned expenditure cuts remain still to be implemented during the remainder of the budget year. The general government deficit in the first half of 2010 amounted to 3.5% of projected annual GDP, lower than the 4.6% recorded in the first half of 2009.

Looking forward, fiscal risks remain significant. The 2011 budget can be considered as an expression of the government's commitment to continued fiscal consolidation. In order to achieve a primary surplus, the budget contains fiscal measures equivalent to around 3% of GDP, including freezes on wages and transfers and significant cuts in spending, which may however be difficult to implement. Moreover, the budget is based on optimistic growth and revenue assumptions and necessary revisions are likely to lead to a higher budget gap, unless the government introduces additional spending cuts or tax increases, posing additional challenges. Risks are also related to contingent liabilities. Additional financing requirements will result from government guarantees provided for the Housing Financing Fund, which indicated the need for recapitalisation. The costs are currently estimated at 2-3% of GDP. A Supreme Court decision of June 16th 2010 declaring foreign-exchange-indexed loans illegal originally introduced considerable uncertainty in the financial system. Before the crisis, banks offered

such loans linked to a basket of foreign currencies with lower interest rates. However, with the collapse of the króna, debt and debt payments in króna increased correspondingly. Following a second Court ruling on this matter in mid-September, which provided some clarifications, the authorities announced legislation to convert illegal foreign currency private household indexed loans to domestic currency loans. These conversions will reduce the outstanding principles of the loans considerably. While the second ruling has reduced risks to the financial system compared to the initial decision, uncertainty over the precise financial implications remains, notably on the treatment of corporate sector loans. The ruling is likely to weaken the banks' equity base, potentially requiring an injection of fresh capital by the government. Furthermore, other significant contingent liabilities arise from a potential settlement of Icesave, the total amount being dependent on recovery rates for Landsbanki's assets and interest rates to be agreed on deposit insurance guarantee obligations. Overall, a process of fiscal consolidation has been launched, primarily supported by tax increases, while the implementation of projected spending cuts remains a challenge. Significant fiscal risks arise from contingent liabilities mainly related to the financial sector.

Gross general government debt increased from around 30% of GDP in 2007 to 88% at end-2009. The increase resulted from the cyclical effects on the budget balance, government borrowing to strengthen foreign currency reserves as well as from the costs of financial sector restructuring. The latter comprises the restructuring and recapitalisation of the three large domestic banks as well as the capital injection into the central bank to cover losses from central bank loans to banks granted on weak collateral. Further progress has been made in establishing a medium-term public debt management framework. This aims to lengthen the average maturity of public debt to 4.5 years by 2011, smooth the profile of debt coming due and reduce the share of debt denominated in foreign currency. To that end, the government concluded agreements on bond buy-backs and other debt regulations. Overall, the government has taken measures to reduce refinancing- and currency risks in view of the high level of public debt.

The policy mix, with a strong focus on exchange rate stabilisation and fiscal consolidation, has been supportive in re-establishing a higher degree of macroeconomic stability. In response to higher trade surpluses and exchange rate appreciation the central bank has introduced a careful easing of monetary conditions by lowering base rates in successive steps. Efforts to strengthen public revenues and implement spending cuts have continued with a view to lowering the public savings-investment gap. However, continued fiscal adjustments remain a challenge and the implementation of the 2011 budget will be an indication as to what extent fiscal consolidation will progress. Finally, macroeconomic stabilisation occurred in a situation of temporary protection through capital account restrictions. Looking forward, their removal will remain a key policy challenge.

### **Interplay of market forces**

Prices of goods and services continued to be determined by supply and demand conditions. As a member of the EEA, Iceland has already liberalised most economic sectors and removed special government protection in most sectors. In the context of the crisis, the government took over the domestic operations of the three major banks that had collapsed. Following recapitalisation and restructuring, the banks' equity was sold to foreign creditors. The government at this time still retains majority ownership (81%) of one of the three banks (NBI) and minority stakes in the other two banks. The private sector accounts for 73% of GDP. Some sectors remain in government ownership, such as the postal services, broadcasting, and parts of the financial sector (including the state-owned Housing Financing Fund). Moreover, the energy sector remained predominantly publicly owned (by the central and local governments), offering attractive wholesale contracts to industry, mostly aluminium companies. Overall, market mechanisms are to a large extent driven by free prices and private ownership, with the exception of some strategic sectors. Efficient financial intermediation is still hampered by the ongoing but still incomplete bank restructuring process.



### Market entry and exit

Starting a business is facilitated by a generally low administrative burden and a supportive regulatory framework. The business environment remained characterised by low bureaucratic hurdles and, in general, efficient administration. However, high barriers to market entry continue to exist in some strategic sectors that are not covered by the EEA such as fisheries, energy, air transport and real estate. Of these, restrictions on investment in fisheries are the only ones that apply to EEA-residents. The recession has significantly affected company start-ups. New business registration dropped further by around 8.5% in the first six months of 2010. Bankruptcy proceedings are generally straightforward and take less time than the OECD average. However, the financial crisis has put a large part of the corporate sector under severe financial distress. The number of insolvent companies increased by close to 8% in the first half of 2010 and the construction sector accounted for the largest share. Firms are suffering from a significant gross debt overhang as outstanding loans to the corporate sector amount to roughly 300% of GDP. Around 9% of outstanding debt is owed by firms already in bankruptcy. Half of outstanding loans to larger companies and one third of loans to SMEs are in default, based on the book value of the loan. Under these difficult circumstances, a new insolvency regime has been adopted to support large-scale corporate debt restructuring. Since court capacity is insufficient to handle a large number of cases, the new regime aims to keep cases out of court to the extent possible while securing creditors' rights. Overall, high barriers to market entry for non-residents remain in key strategic sectors and market exit is complicated by a large corporate sector debt overhang.

### Legal system

The legal system continued to support a business-friendly investment climate. It offers good protection and enforcement of property rights and provides a clear and stable framework for agents to take economic decisions in a situation of legal certainty.

### Financial sector development

The reconstruction of the banking sector has progressed. The market remains dominated by the three 'new' banks that emerged from the financial collapse in autumn 2008. They have been recapitalised and are now much smaller in size compared to pre-crisis levels, focusing on domestic operations. Domestic credit to the private sector is estimated at 110% of GDP in mid-2010, only a fraction of the pre-crisis level. The government retains majority ownership in one of the banks, and minority stakes in the other two banks; with the majority stakes (indirectly) owned by non-residents. However, the banks are faced with significant vulnerabilities as asset quality is subject to considerable uncertainty. Assets are largely denominated in or indexed to foreign exchange whereas liabilities are in domestic currency and at variable interest rates. Private households and businesses are faced with significant operational problems and default is widespread. Efforts have been made at private sector debt restructuring, but due to its complexity, the process has advanced more slowly than expected. The sheer magnitude of balance sheet imbalances poses a significant challenge to financial sector stability, in spite of banks' currently rather high capital adequacy ratios (16%). Non-performing loan ratios are exceptionally high. Currently, just under one fifth of the banks' restructured loans are being paid on time, while 40% are in default. Write-offs are likely to increase, weakening the profitability and capital base of banks. In addition, the Supreme Court decisions on loans indexed to a foreign exchange clause could further erode the financial situation of the domestic banks. Furthermore, banks are currently relying to a large extent on domestic deposits. This source of financing has been growing slowly despite the government's blanket deposit guarantee, which has recently been increased. Looking forward, the deposit base could weaken as other investment opportunities arise (and capital controls are lifted). At the same time, foreign direct investment and access to foreign credit still remains limited. The restructuring and recapitalisation of the savings banks has further progressed, but savings banks remain burdened with foreign exchange risks due to balance sheet mismatches. Overall,

banking sector restructuring has further progressed, but significant vulnerabilities remain with respect to banks' asset quality and capitalisation.

Further progress has been made in strengthening bank regulatory and supervisory practices. A new legal framework aims to improve risk management systems and governance, strengthens provisions on large exposures and connected lending, and enhances fit and proper requirements for major shareholders. Moreover, the discretionary powers of the Financial Supervisory Agency have been strengthened, inter alia through the setting up of a large exposures credit registry to reinforce control and transparency. Also, deposit insurance regulations are being revised to bring coverage into line with EU legislation.

The non-banking financial sector comprises the government-owned Housing Finance Fund, investment banks, leasing companies, payment card companies and investment credit funds. Total credit provided by the sector grew by 10% in 2009, reaching the equivalent of 60% of GDP, but the increase was largely due to loan indexation rather than to new borrowing. The government-owned Housing Financing Fund represents two thirds of the sector's total assets and private households constitute by far the largest group of the Fund's borrowers. However, many of the institutions continued to suffer from equity problems, a weak capital base and uncertainties with respect to future financing. The financial situation of the Housing Financing Fund has been undermined by the weakening performance of its loan portfolio, which had induced the Fund to introduce household debt restructuring measures and to encourage its borrowers to utilise government programmes. Increases in defaults led to a significant decline in the equity ratio below the envisaged long-term threshold. A government capital injection is currently being considered. Overall, a large part of the non-banking financial sector remains confronted with significant credit risks and weak equity ratios.

Since the collapse of markets in late 2008, domestic equity markets have been playing a much smaller role in financial intermediation. The lack of confidence in the equity market is reflected in extremely low turnover, which in 2009 reached 4% of the 2008 turnover. The market value of all listed companies stood at 17% of GDP (end-April 2010), compared to 120% prior to the crisis. In contrast to equity markets, turnover on bond markets seems to have recovered rather strongly, also due to rising demand for government-guaranteed bonds following the failure of the domestic banks. The market capitalisation of all listed bonds increased to close to 100% of GDP (end-April). Overall, domestic financial markets have somewhat recovered on the back of a more lively bond market while confidence in equity markets remains rather weak.

## **2.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

### **Existence of a functioning market economy**

Given the serious impact of the banking crisis, the country's economy has not yet recovered a level of macro-financial stability allowing for an efficient allocation of economic resources. The balance sheets of private households and non-financial firms have been seriously damaged and a large number of firms are in the process of or about to enter into debt restructuring. Under these circumstances, investment activity remains markedly restrained, holding back the recovery process. An efficient allocation of resources remains rather limited in parts of the economy, also due to financial sector weaknesses and capital restrictions. Overall, there remains scope for improving the functioning of markets.

### Human and physical capital

The economic crisis severely affected the labour market situation. The unemployment rate increased from 3% in 2008 to 7.2% in 2009; the activity rate dropped from close to 87% to around 85%. Moreover, the unemployment rate of the young population has doubled to 16% and the share of long-term unemployed has risen markedly. The government continued to implement active labour market policies aimed at retraining and upgrading skills of the labour force. However, with unemployment well above equilibrium levels, human capital remains significantly underutilised. The crisis has also led to an increase in outward migration of professionals and high-skilled workers. Despite the crisis, education spending has slightly increased to around 7.8% of GDP in 2009 (from 7.6% in 2008), but is foreseen to drop in 2010 and 2011. The country enjoys a strong capital endowment and the basic infrastructure is in line with the high income level of the economy.

Abundant geothermal sources have attracted substantial foreign investment in the aluminium and hydropower sectors over the past, but the financial crisis has put several investment projects on hold. The share of investment in GDP has fallen markedly in the context of the crisis, from around 30% over previous years to 12% in 2009. Investments in the manufacturing sector (aluminium, food processing) have been particularly affected, but they have also dropped in the energy and construction sector. At the same time, the fall in real estate activities reflects also some normalisation following the earlier 'boom' years. Public investments have also fallen, from 4% to 3% of GDP, with the largest declines in transport infrastructure. Inward FDI was negative in 2009 as foreign investors reduced their exposure; however, the net FDI balance remained positive as residents reduced outward investments to a much larger extent. The total stock of inward FDI remained at around 75% of GDP.

Spending on research and development has remained high at around 2.7% of GDP.

Overall, the country enjoys good basic infrastructure, abundant natural resources, and a generally well educated population. Investments remain concentrated in a few manufacturing sectors.

### Sectoral and enterprise structure

Although some new segments in manufacturing and services have expanded over the past years, in particular in some high-tech areas such as software production and biotechnology, the economy's industrial sector is characterised by a limited degree of diversification. The relatively small industrial sector (excluding construction), mainly steel manufacturing, represents roughly 9% of output and one fifth of employment. The share of the service sector in total output declined somewhat in the context of the crisis, mainly due to reduced economic activity in the real estate, retail trade and financial sectors. However, services still account for two thirds of the economy and almost three quarters of employment. Tourism and transport continued to be an important source of foreign exchange income in 2009, accounting for a quarter of total export earnings. However, in the first half of 2010, the number of foreign tourists dropped by 1.2% year on year, probably due to volcanic activity. Lastly, the share of construction in GDP has fallen markedly, from around 10% of GDP over previous years to 7.4% in 2010, reflecting adjustments in an over-leveraged sector as well as completion of large energy-related projects.

Regarding network industries, energy production is predominantly publicly owned, but third party access to transmission and distribution is granted. Non-nationals are not granted market access to production. The telecommunication sector is liberalised and privately owned while government interventions remain limited to infrastructure investments in remote areas.

The importance of small firms in the economy remains high, accounting for 99% of the total and 70% of employment and output.

Overall, the country's industrial sector remained not very diversified and the construction sector is in a process of deleveraging.

### **State influence on competitiveness**

The relatively small agriculture sector continued to benefit from government subsidies, import protection, and a system of production quotas. Certain industries, such as, energy, air transport and fishing remain heavily protected from foreign competition as non-residents from the EEA and/or third countries are not granted access to markets. The level of state subsidies amounts to 1.8% of GDP. The fishing industry, however, does not receive any kind of state support from the budget but its future structure and performance is to a large extent contingent upon choices to be made by the state as regards the domestic allocation of fishing quotas. Energy production remained in government ownership, with large consumers being offered relatively favourable electricity prices. Following its intervention in the banking sector, the state continued to divest by selling its shares; it retains majority ownership of one of the three new banks. The government announced that it will continue the restructuring of the savings banks sector. While the government announced it would give creditors a chance to hold most of the equity, the process will involve some state support. The Housing Financing Fund remained state-owned and indicated it requires recapitalisation with public funds. State interference remains significant in some areas, including the banking sector as long as its restructuring and privatisation is not completed.

### **Economic integration with the EU**

Iceland is an open economy with total trade in goods and services representing around 95% of GDP. The country's export structure is not very diversified. Marine products and aluminium account for two thirds of merchandise exports. The share of services, mainly travel and transport, has increased to around one third of total exports. The import structure is much more diversified, reflecting the country's dependence on a wide range of manufactured goods and some commodities. The EU has continued to be the largest trading partner. Its share in Icelandic merchandise exports increased to over 80% (January to April 2010, from around 75% a year before), and half of the country's imports originate in the EU. Overall, integration with the EU in the areas of trade and investment remained high.

In 2009, real wages declined on average by 7.3% as annual inflation (12.3%) was significantly higher than the growth of average nominal wages (3.9%). The increase in nominal labour costs was more pronounced in the non-tradable sectors (e.g. construction) compared to the tradable sector (e.g. manufacturing, transport, storage, communication). Rough estimates point to a slight deterioration of average labour productivity in 2009, suggesting an increase in unit labour costs. The exchange rate of the króna vis-à-vis the euro has appreciated by around 15% in the first nine months of 2010. In real effective terms (trade-weighted and adjusted for price differentials) a similar significant appreciation took place, suggesting a deterioration in price competitiveness vis-à-vis the main trading partners. An analogous picture arises for the real exchange rate when measured on the basis of unit labour costs. Overall, recent changes in indicators suggest a real appreciation of the króna. However, this reflects a gradual rebound from the strong overshooting in the aftermath of the financial crisis, when the domestic currency lost half of its value vis-à-vis the euro.

### **2.3. Conclusions**

The economy of Iceland went into a deep and long recession and prospects for even a mild recovery remain uncertain. Unemployment has increased and public finances have suffered a marked deterioration with higher fiscal deficits and a significant rise in the already high public debt. On the other hand, inflation has been gradually and steadily coming down. A prudent macroeconomic policy mix focuses on exchange rate stabilisation and fiscal consolidation. A still dysfunctional financial

sector and widespread private sector balance sheet imbalances as well as a very high external debt represent key challenges. The IMF programme has been on track.

As regards the economic criteria, Iceland can be considered a functioning market economy. However, financial sector weaknesses and capital movement restrictions still impede an efficient allocation of resources. Iceland could regain the capacity to cope with competitive pressures and market forces within the single market over the medium term, provided that it continues to address current structural weaknesses through appropriate macroeconomic policies and structural reforms.

The policy response has by and large been appropriate and supportive to re-establish a higher degree of macroeconomic stability, although prospects for a swift resumption of economic growth remain uncertain. Fiscal consolidation continued; fiscal deficits have started to decline and public debt has been restructured with a view to smoothing its profile and reducing exchange rate risks. Inflation has come down and key policy interest rates have been gradually lowered. A higher trade surplus has supported a slight appreciation of the domestic currency. Foreign exchange reserves have increased, however this was achieved largely on the basis of official external financing. The labour market remained flexible and participation rates relatively high. The country enjoys good basic infrastructure, abundant natural resources, and a well-educated population.

However, the economy is still struggling with the effects of the financial meltdown. Public finances remain confronted with the challenge to implement severe spending cuts and suffer from significant contingent liabilities related to financial sector distress, with a gross general government debt level of almost 90% of GDP. Despite real wage adjustments, unemployment has risen markedly. The reconstruction of the banking sector has progressed, but banks are still suffering from weak asset quality which undermines their ability to finance the economy. Widespread private sector balance sheet imbalances pose threats to financial stability. In addition, Supreme Court rulings declaring foreign exchange indexed loans illegal created uncertainty, notably on the treatment of corporate sector loans. This could further erode the financial situation of domestic banks as they would have to shoulder the additional burden instead of borrowers. The process of corporate sector debt restructuring has progressed slowly and the debt overhang is limiting the scope for new investment, holding back the recovery. Investment in large infrastructure projects is currently still under review because of political discussions and lack of funding. The business environment remained hampered by capital controls, relatively high interest rates and difficult access to financing, especially for SMEs.

## 3. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

In examining economic developments in the former Yugoslav Republic of Macedonia, the Commission's approach was guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

A broad consensus on the fundamental features of the country's economic policy has been maintained. As in previous years, the country is participating in the EU pre-accession fiscal surveillance procedure. It presented its fourth Pre-accession Economic Programme in February 2010 and submitted its fifth Fiscal Notification in May 2010. However, the preparation, submission and quality of the information provided were impeded by constraints on administrative capacity. Cooperation with the World Bank and the IMF has continued. Furthermore, a number of medium-term strategies define the policy framework, such as the public investment programme for 2010-12, the fiscal strategy 2010-2012 and the public debt strategy for 2010-12. Structural reforms continued in a number of areas, although progress was slower than in the past. Overall, a broad political consensus on the fundamentals of economic policy has been maintained.

#### Macroeconomic stability

In 2009 the economic output in the country declined by 0.8%. The impact of the financial crisis on the economy has remained relatively limited so far, partly due to the financial sector's limited exposure to toxic assets, but also to the stable private capital inflows and resilient domestic demand. During the first three quarters of 2009, GDP declined by 1.7% compared to the same period a year before, while the fourth quarter of 2009 saw positive year-on-year growth of 1.6%. In the first quarter of 2010, the output level was about 1% lower than a year before, while in the second quarter output rose by 0.4% year-on-year. Compared to the first half year in 2009, the output level was still 0.3% lower than a year before. The decline in private and public demand remained moderate, while investment dropped by nearly 20%. The reduction in domestic demand was accompanied by a similar decline in imports, while exports rose by 15%. Several indicators, such as industrial production, point to continued weak demand for manufactured products. Average per capita GDP remained stable in absolute terms during, however, in relation to the EU-27 average it improved from 34% of the EU-27 average in 2008 to 35% in 2009. Overall, after a moderate decline in economic activity during the first three quarters of 2009, indications of a recovery in 2010 are still unclear.

External balances improved during the reporting period, as a result of declining imports, improving exports and a recovery of private capital inflows. The current account deficit declined, from nearly 13% of GDP in 2008 to about 7% in 2009 and 3.8% of GDP on an annualised basis in mid 2010. In the first half of 2010, commodity imports increased year-on-year by 6.5%, while export revenues rose by 23%. As a result, the trade deficit narrowed from 24.5% of GDP in the first half of 2009 on an annualised basis to 22% of GDP in the first half of 2010. The inflow of private transfers increased from 11.4% of GDP in the first half of 2009 to 18.8%. FDI inflows remained low, at around € 115 million or annualised 3.7% of GDP. Foreign reserves recovered from marked losses in early 2009, reaching coverage of expected imports of close to 5 months. Foreign debt increased, mainly due to private sector intercompany lending but also higher public sector borrowing abroad. Overall, external imbalances improved due to both, shrinking imports reflecting weakening domestic demand and improving external demand. Private capital inflows remained strong.

Unemployment in 2009 remained very high at 32.2% and continued to increase in 2010. The overall labour market situation was stable in 2009, while the first half of 2010 saw a deterioration, with a year-on-year employment decline by 1%. The employment decline reflects a significant drop in officially registered employment in agriculture (by nearly 5% compared to a year before), partially compensated by a similar increase in public sector employment (mainly in education and community services). About 20% of the unemployed are between 15 and 24 years old. Unemployment in this age group has remained very high at around 55% (June 2010). Even though the existence of a substantial informal sector leads to overestimation of actual unemployment, very high unemployment remains an important issue, in particular among young people and the less educated. Overall, the situation in the labour market started to deteriorate in early 2010. However, increases in public sector employment partially offset the negative impact of the global financial crisis on the labour market. The level of unemployment remains very high, in particular among the young and less educated.

Table 3.1:

**The former Yugoslav Republic of Macedonia - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	4.1	4.0	6.1	5.0	-0.8	-0.4
Private consumption	Ann. % ch	5.7	6.0	9.8	8.1	-4.1	3.5
Gross fixed capital formation	Ann. % ch	-5.4	11.6	13.3	16.5	N.A.	N.A.
Unemployment	%	37.3	36.0	34.9	33.8	32.2	32.8
Employment	Ann. % ch	4.3	4.6	3.5	3.2	3.4	-0.9
Wages	Ann. % ch	2.7	8.0	4.8	8.7	14.1	0.7
Current account balance	% of GDP	-2.6	-0.4	-7.1	-12.7	-7.2	-2.7
Direct investment (FDI, net)	% of GDP	1.6	6.8	8.5	6.1	2.5	2.5
CPI	Ann. % ch	0.5	3.2	2.3	8.3	-0.8	0.8
Interest rate (3 months)	% p.a.	9.95	6.40	5.60	6.69	N.A.	N.A.
Stock markets	Index	1,930	3,219	6,971	5,149	2,497	2,679
Exchange rate MKD/EUR	Value	61.30	61.19	61.18	61.26	61.28	61.48
Nominal eff. exchange rate	Index	99.8	100.0	99.6	100.6	106.6	106.1*
General government balance	% of GDP	0.2	-0.6	0.6	-1.0	-2.7	N.A.
General government debt	% of GDP	46.9	40.2	27.3	28.8	32.1	N.A.

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Monetary and exchange rate policy have remained stability-oriented. The Central Bank managed to maintain the de facto peg. Since October 2009, the Central Bank has lowered interest rates for short-term Central Bank bills from 9% to 4.5%, taking advantage of the recovery of confidence in the stability of the exchange rate and trying to support the economy through lower interest rates. Private-sector weighted interest rates declined after their peak in the last quarter of 2009. Rates for denar loans declined from 10.3% in September 2009 to 9.6% in May, while the rates for denar deposits declined from 7.5% in December to 7.1% in May. Spreads continued to narrow slightly, from 2.8% in autumn 2009 to 2.5% in May. The speed of credit growth decelerated towards end-2009, but has started to accelerate again. Overall, the exchange rate policy and monetary policy have remained sound and stability-oriented.

Inflation in 2009 was negative at -0.8%. After a strong rise in the overall price level in 2008, consumer prices turned negative in 2009 mainly due to lower food prices. In 2010, CPI inflation remained moderate, with a year-on-year increase by 1.1% during the first nine months. As in 2009, the main contribution to low inflation came from declining food prices, which were 0.9% lower on average during the first nine months of 2010, while prices for fuel and lighting rose by 8.8%, partly due to higher costs of imported energy. Prices for housing increased by 6.8%. Core inflation, which excludes the impact of energy and food prices on the overall price level, was 2.6% in 2008, but declined to 0.3% in 2009. In 2010, core inflation has remained close to zero.

The overall fiscal policy stance in late 2009 and the first half of 2010 has been oriented towards cushioning the impact of the global financial crisis, while trying to meet previously announced fiscal

deficit targets, i.e. 2.8% of GDP in 2009 and 2.5% in 2010. In 2009, the authorities were confronted with a 6% decline in revenues, instead of an expected 6% increase. Thus, the government had to abandon overly optimistic spending plans and to cut total spending by 0.5%, instead of boosting it by 10% as envisaged in the original 2009 budget. As a percentage of GDP, total spending remained unchanged (at around 35% of GDP), while revenues as a share of GDP declined by almost 2 percentage points, leading to an increase in the deficit from 1% of GDP in 2008 to 2.7% in 2009. Despite declining revenues, the government kept to its original plan of lowering direct taxes and also granted tax reliefs to some public and a number of private enterprises. Furthermore, the authorities increased social transfers and subsidies. These additional measures amounted to slightly more than 1% of GDP and supported both, the disposable income of households but also some chronically troubled companies. However, in order to meet the original deficit target, the authorities reduced capital spending by the same amount. Thus, while overall spending has remained largely unchanged, the quality of spending has deteriorated. This is due to increased transfers at the cost of more medium-term oriented spending, such as capital investment in infrastructure or education. In the first half of 2010, fiscal balances have remained on track with the end-year deficit target of 2.5% of GDP. However, in recent months, the government seems to have accumulated substantial payment arrears, which strain the private sector's liquidity and could translate into a significantly higher accrual based deficit. In order to finance the deficit, the government resorted to reserves and international lending, which resulted in an increase of public debt by 3 percentage points in 2009, from 21.4% of GDP at end-2008 to 24.6% by end-2009. Fiscal decentralisation continued, with further measures to strengthen the fiscal viability of indebted municipalities. Overall, fiscal policy tried to support disposable income but maintained internal and external balances. This helped to stabilise the economy. In the medium term, the government's recent approach of lowering revenues while maintaining or increasing spending is not sustainable.

The overall macroeconomic policy mix remained stability-oriented. In response to the crisis, monetary conditions were gradually relaxed, taking into account the country's policy of a de facto peg to the euro. Public spending was largely maintained despite a significant drop in revenues. This helped to stabilise disposable income and domestic demand. However, increases in transfers and subsidies were mainly financed by cutting capital spending, which had a negative impact on the quality of public spending. Furthermore, lack of discussion with the country's stakeholders had a negative bearing on the quality of the measures taken. Overall, the general policy mix improved, trying to respond to the negative impact of the crisis, while keeping in mind the need to maintain macroeconomic balances. However, the quality of public finances deteriorated and the issue of high unemployment, in particular among the young, remains a major policy challenge.

### **Interplay of market forces**

Privatisation is largely completed and the economy is mainly driven by market forces. The private sector accounts for 81% of total output and 78% of total employment. After a marked, mainly crisis-related increase in the number of companies with state shares in 2008 and 2009, the number of companies with state shares remained stable at close to 70. The value of state capital in local companies amounts to 13% of GDP. The majority of state capital, - 78.5% - is concentrated in five companies, mainly public utilities, such as electricity production and transmission, where the state is majority owner, and telecommunications, where the state is a minority owner.. The practice of setting electricity prices below full cost recovery continues and leads to distortions in the domestic price structure. Overall, the role of state ownership is low and mainly limited to telecommunication, energy and public services.

### **Market entry and exit**

The government has continued improving legislation on market entry and exit. The implementation of the second phase of establishing a 'one-stop-shop' for business start-ups has continued. The costs of



registration have been reduced further. The process of simplifying regulation, the so-called business guillotine, has entered its third phase, with a particular emphasis on improving the regulation-related dialogue with the business community. The process of closing down companies, overdue to be wound up, has continued. The number of newly created enterprises was 11% lower in the first eight months than a year before, while the number of new bankruptcies was 18% higher than a year before. However, the number of enterprises deleted from the trade registry declined by only 5.8%. The backlog in bankruptcy cases has been further reduced. Overall, barriers to market entry are rather low and some further progress has been achieved in reducing entry barriers and improving market exit.

### Legal system

The legal system for a functioning market economy is largely in place. The registration of real estate ownership rights is practically completed, compared to 90% in September 2009. The National Electronic Registry (ENER), which provides information on draft legislation and a platform for stakeholder consultation, and the Insurance Supervisory Agency (ISA) have started operating. Furthermore, a private credit bureau has been established and the Company Law and the Litigation Law have been amended. However, no progress has taken place on speeding up legal procedures, as the entry into force of the amendments to the Law on contract enforcement has been postponed for another year, to July 2011. Despite improved legal and financial independence of regulatory and supervisory bodies, the administrative capacities and the enforcement record of some of those institutions, such as the State Anti-Corruption Commission (SACC), or the energy regulator, continue to be limited. As a result, some regulatory and supervisory agencies are not yet fulfilling their role as guardians of the rule of law and providers of a level playing field for all economic operators. Overall, some progress in improving the legal system has been achieved, such as further clarification of real estate ownership rights. However, weaknesses in the rule of law, notably in the judiciary, which is characterised by slow procedures insufficient resources and unreliable contract enforcement, and prevalent corruption continue to have a negative effect on the business environment.

### Financial sector development

The financial sector has remained stable and has so far weathered well the financial market turbulences. The value of financial assets recovered to pre-crisis levels, increasing from 66% of GDP end 2009 to 68.3% in mid 2010. The level of financial intermediation is relatively low, but recovered marginally, with the share of loans increasing from 42.7% of GDP end 2009 to 43.7% in mid 2010 and deposits rising from 46.2% end 2009 to 48.6% in mid 2010. Deposits continue to be the sector's main source of liquidity. The coverage of loans through deposits is still above 100. The volume of loans has started to recover since spring and was in mid-2010 some 3-4% higher than a year before. However, the rate of increase is significantly lower than before the crisis. The low level of financial intermediation in combination with a cautious lending policy of the banking sector helped to contain the impact of the global financial crisis. However, the high thresholds for companies, in particular SMEs, to get access to credits also constrain the private sector's growth potential. The capitalisation of bond and stock markets recovered in the second half of 2009, but has been declining since the beginning of the year. Currently, the value of the capital market accounts for about 30% of GDP (stocks 23% and bonds 7%), which is the level recorded in 2005.

The structure of the sector has remained largely unchanged. The share of state ownership in the sector remains low, at 7% of the sector's assets. The main state asset is the majority share in the country's only development bank and a limited number of remaining minority shares in private banks. There are 18 banks and 9 savings houses operating in the market, with the five largest banks accounting for three quarters of the sector's assets and deposits. The efficiency of financial intermediation has continued to increase slightly, as indicated by the continued slight decline in the spreads between lending and borrowing rates, from some 3 percentage points in September 2009 to 2.5 percentage points in mid-2010. Profitability in the sector has remained low in the aftermath of the crisis: for

example, the return on assets was 0.4% in mid-2010, compared to 0.5% the year before. The size of the non-banking financial sector has remained small, at 5% of the total sector's funds. However, regulation and supervision of this sector has improved, with closer supervision of the stock exchange through the Securities and Exchange Commission and the establishment of an Insurance Supervisory Agency.

Despite continued uncertainty, the stability of the sector has been maintained, benefiting from the stricter regulatory standards and stronger supervisory capacity introduced in the last few years. However, the exposure of the banking sector to non-performing loans deteriorated in the first half of 2010, increasing to 10.1% of loans, compared to 8.8% in the last quarter of 2009 and 7.5% a year before. Loans with a foreign currency component remained stable at 54% of total loans. The capitalisation of the banking sector remained high, with an average capital adequacy ratio of 16.5% in mid 2010. Large banks reported an average capital adequacy ratio of 14.3% and small banks as high as 43.4%. Overall, the financial sector weathered the international financial crisis relatively well, benefiting from low exposure to toxic assets and a cautious lending policy. However, financial intermediation has remained low, impeding more dynamic growth of the private sector, in particular of SMEs.

### **3.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

#### **Existence of a functioning market economy**

Overall, macroeconomic stability has been maintained despite the negative impact of the global financial turbulence. Despite some improvements in the area of market entry and exit, and with respect to the legal system, the business environment continues to be impaired by the weak rule of law, notably by a slow judiciary and weaknesses in contract enforcement, market regulation and supervision. Structural unemployment remains very high. Predictability of market conditions has suffered from an increased number of ad hoc changes to the legal environment.

#### **Human and physical capital**

The authorities kept up efforts to improve the physical infrastructure for education and have taken measures to provide higher education to a greater number of persons, for example by establishing decentralised tertiary education facilities. Budgetary allocations for education were at around 5% of GDP in 2009, but were slightly reduced in the 2010 supplementary budget. Like last year, a significant share of spending has been on renovation and construction of school buildings and the purchase of IT equipment. The number of teachers in primary and secondary schools has been further increased, in particular in the area of secondary education and foreign languages. However, further efforts are required to improve the quality of the provided education. Despite continued efforts, the overall level of education and training of the labour force is still relatively low. In particular, the skill mismatch still is substantial. There remains significant room for improving the efficiency of public spending on education and for raising the quality of education. Overall, measures to improve the level of qualification have continued. However, the still low level of education requires further sustained efforts in order to improve the country's human capital endowment.

The country's capital endowment has remained relatively low and its quality is still suffering from previous periods of underinvestment. Some further progress has been made on improving the transport infrastructure. However, as a result of crisis-related uncertainty and fiscal constraints, private domestic investment has declined sharply during the last year. Furthermore, continued low level of legal certainty had a negative impact on inflows of FDI, which in 2009 and the first half of 2010 have remained low, at 3.7% of GDP. In some cases, persistently slow legal procedures, fragmentation of

responsibilities between central and local governments and an ongoing dispute related to investor protection continue to be an impediment to FDI. Spending on strengthening the knowledge-based economy has remained low. Capacity of administration to serve the businesses remained impeded by frequent staff reallocations and time consuming procedures. Overall, the country's capital stock continued to be low, indicating a low attractiveness of the country for foreign capital. Infrastructure continues to require repair and modernisation.

### **Sectoral and enterprise structure**

The focus of economic activity has continued to move away from manufacturing towards services. However, in the past two years, the public sector was the only sector increasing substantially both, its share in employment, but also its share in terms of output generation. Financial intermediation continued to be the most important and growing sector with about 20 % of GDP, followed by public administration which grew by almost 1 percentage point to about 19% of GDP while agriculture continued to decrease to about 17%. In terms of employment, services in particular public administration and trade grew in importance. In terms of enterprise creation the trading sector was most dynamic. The informal sector remains large, although there are indications that it has been reduced, for example by improving tax collection, lowering the tax burden, reforming collection of social security contributions and providing financial incentives for registration. The informal sector is fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime. It reduces the tax base and the efficiency of economic policies. Gas and electricity markets remain dominated by single suppliers, undermining effective competition. In the sectors of telecommunication and transport, no significant structural change has taken place. Overall, structural change towards diversification and activities with higher value-added has remained limited. Competition in network industries remains constrained by dominant incumbent suppliers. The large informal sector remains an important challenge.

### **State influence on competitiveness**

Direct state influence on competitiveness has increased as a result of more frequent state interventions to shield troubled companies from the impact of the international financial crisis. However, the overall level of systematic state intervention is still low. Energy prices still do not cover the full costs, which leads to distortions in relative prices and to substantial losses on the part of state-owned energy providers. Official data point to a low level of state aid, less than 1% of GDP. However, this figure is not comparable to state aid data compiled in accordance with EU standards. The institutional setup for monitoring state aid and competition issues is in place. However, the agency's capacity to guard a level playing field among market participants is limited. Overall, state influence on competitiveness remained low, although state interventions were more numerous than in the past.

### **Economic integration with the EU**

The country has a small, open economy, with total trade in goods and services accounting for close to 100% of GDP (2009). However, as a result of the crisis, the level of both exports and imports has declined. Trade integration with the EU is advanced, with currently about 62% of all exports being directed to and about 53% of imports originating from the EU-27. CEFTA is the country's second most important trading partner, with about 31% of exports and about 12% of imports. The export structure continues to be highly concentrated on a limited range of products, with textiles and clothing accounting for about 24% of total exports and manufactured iron products for 26%. In terms of FDI, the EU is the country's main investor, accounting for about 60% of total FDI inflows. Overall, trade integration with the EU is well advanced, but exports remain concentrated on a few price-sensitive products.

International price competitiveness remained unchanged. The exchange rate against the euro has remained stable in nominal terms.

### **3.3. Conclusions**

The economy of the former Yugoslav Republic of Macedonia contracted only slightly due to the financial sector's low exposure to toxic international assets, resilient private capital inflows and a stable public sector. Structural reforms have continued. However, high structural unemployment, in particular among young and poorly educated, remains a major cause of concern. Some minor improvements have been achieved with respect to addressing institutional weaknesses, but deficiencies in the rule of law continue to have a negative bearing on the business climate.

As regards the economic criteria, the former Yugoslav Republic of Macedonia continues to be well advanced. In some areas, it has made further progress towards becoming a functioning market economy, notably by reducing barriers to market entry and exit and improving the capacity of the courts to handle economy-related cases. It should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it vigorously implements its reform programme in order to reduce significant structural weaknesses.

The country has maintained a broad consensus on the essentials of economic policies. Monetary policy, based on the de facto peg to the euro, contributed to macro-economic stability. After an expansionary approach in 2008, fiscal policy became more stability oriented during 2009. The country's external balances improved, reflecting a slight recovery in exports, a drop in imports due to weak domestic demand, and strong private capital inflows. Privatisation is largely completed. Price and trade liberalisation has been largely accomplished. Some further progress has been achieved in improving market entry and registration and in simplifying the regulatory framework. The duration of bankruptcy procedures has been further reduced and property registration is largely completed. The financial sector weathered the crisis well and the independence of some of its supervisory and regulatory agencies has been strengthened.

As a result of widening fiscal deficits, public sector debt increased. The quality of public spending deteriorated, partly due to a decrease of medium-term oriented capital spending. Unemployment remained very high. FDI inflows continued to decelerate from an already low level. The functioning of the market economy remained hampered by institutional weaknesses, lack of stability in the administration and weaknesses in the rule of law. Lack of consultations with stakeholders prior to government decisions hampers the predictability of the business environment. The judiciary is still a bottleneck and regulatory and supervisory agencies sometimes continue to lack the necessary independence and resources to fulfil their functions effectively. The degree of legal certainty remains low, which has a negative bearing on the country's attractiveness for foreign investment. The informal sector remains an important challenge.

## 4. TURKEY

In examining the economic developments in Turkey, the Commission's approach was guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

The Pre-Accession Economic Programme (PEP) submitted to the Commission in January 2010 adequately reflects needs and commitments to further reform. It draws largely on the Medium-Term Plan (MTP) published in mid-2009. The government's new MTP, due by October 2010, should focus on the recovery conditions. The authorities largely adhered to the economic policy principles as reflected in the International Monetary Fund's (IMF) Article IV report. The fragmentation of responsibilities between government bodies, however, continues to complicate coordination of budgeting and medium-term economic policy-making. Another challenge that Turkey is facing is to lock in its future economic success and stability in a consistent and comprehensive framework aimed at broader-based productivity growth and higher labour market participation. Strong inflationary pressures and a rapidly growing current account deficit have to be carefully monitored and addressed properly. Overall, consensus on economic policy essentials has been preserved. However, confidence in the government's economic policy stance would benefit from better planning, coordination and communication.

#### Macroeconomic stability

GDP contracted by about 5% in 2009, a sharp contrast to the 6% average annual growth rate in the period 2004-08 and the growth of 0.7% in 2008. Turkey's GDP per inhabitant stands at 46% of the EU average. The global financial crisis hit the economy hard dramatically reducing fixed investment and external demand. Fiscal and monetary stimulus measures, combined with a healthy banking sector, helped cushion the blow. After a severe contraction in the first half of 2009, economic growth resumed in the second half and then gained pace in the first half of 2010 recouping the output lost in 2009. Domestic demand drove the fastest expansion in almost six years. Real GDP increased in the first half of 2010 by 11% from a year earlier, up from 2% in the second half of 2009, reflecting a very significant recovery over the last year. All sectors demonstrated strong positive growth: trade, industry and construction expanded by over 15% in the first semester of 2010. Domestic demand and in particular investment were particularly strong, as the year-on-year growth in gross fixed capital formation amounted to a sheer 22%. The high growth in domestic demand translated into imports growth amounting to 20%. Net exports pulled down the growth performance by 3.4%. Consumer and corporate loans have maintained their rapid pace and continue to spur domestic demand. High frequency indicators point at a growth slowdown – albeit gradual and from very high levels – starting in mid-2010. Overall, the Turkish economy has demonstrated high resilience. It is recovering rapidly from the crisis and growing at robust rates since mid-2009.

Pressures on the current account – which had seen a major crisis-led improvement – started in late 2009, as robust domestic demand and higher energy prices fuelled imports, which increased by 30% in the first half of 2010. In tandem with the rise in imports, exports performed relatively well and rose by about 15% in the first six months of 2010. Consequently, the trade deficit more than doubled passing from 3% of GDP in the first half of 2009 to 6.2% of GDP in the same period in 2010. The current account balance broadly shows similar patterns and the deficit is widening rapidly. In the first six months of 2010, the deficit amounted to 6.2% of GDP, compared with 2.7% in the same period of 2009. Total financing needs have almost doubled in 2010. The financing has been shifting

dramatically towards more portfolio and in particular more cross-border credits to domestic banks (covering two thirds of the current account deficit) and less direct investment. Reserves rose by about €4 billion to roughly €40 billion. The gross external debt stock amounted to 37% of GDP in the first half of 2010, down by about five percentage points from the same period in 2009. About two thirds is held by the private sector. Overall, external imbalances and financing needs have been growing significantly on the back of high domestic growth. Access to external finance remained unproblematic.

**Table 4.1:**  
**Turkey - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	8.4	6.9	4.7	0.7	-4.7	11.0
Private consumption	Ann. % ch	7.9	4.6	5.5	-0.3	-2.2	7.4
Gross fixed capital formation	Ann. % ch	17.4	13.3	3.1	-6.2	-19.1	22.0
Unemployment	%	10.2	9.9	9.9	11.0	14.1	12.7
Employment	Ann. % ch	1.7	-0.4	-3.6	1.3	0.4	7.5
Wages	Ann. % ch	12.4	11.0	9.5	11.3	9.7	10.1*
Current account balance	% of GDP	-4.6	-6.1	-5.9	-5.6	-2.3	-4
Direct investment (FDI, net)	% of GDP	1.9	3.6	3.1	2.1	1.0	0.8
CPI	Ann. % ch	8.2	9.6	8.8	10.4	6.3	9.3
Interest rate (3 months)	% p.a.	16.74	18.07	18.85	18.04	10.68	7.77
Stock markets	Index	29,353	39,867	48,270	37,582	37,510	54,972
Exchange rate TRY/EUR	Value	1.67	1.80	1.78	1.91	2.16	2.02
Nominal eff. exchange rate	Index	28.1	26.2	26.7	25.8	23.2	23.7*
General government balance	% of GDP	-0.6	-0.1	-1.0	-2.2	-2.4	-3.7
General government debt	% of GDP	52.3	46.1	39.4	39.5	43.7	42.4

\* Industrial Sector, Q1

Sources: Thomson Reuters/Ecowin, Eurostat

In 2009, the unemployment rate amounted to 14%. In tandem with the recovery, the unemployment rate declined to 11% by mid-2010 from 13% in mid-2009. The non-farm unemployment rate, which stood at 17% in mid-2010, showed a broadly similar downward trend. The youth unemployment rate dropped faster, most likely due to the priority given to this segment in the employment package, to 20% from over 24% in July last year. Employment data show a marked improvement, as the number of employed increased by over 1,000,000 compared with July last year. The employment rate went up from 42% in mid-2009 to 44% in the same period of 2010. Female labour participation increased by over 1.5 percentage points since mid-2009, but female employment remains particularly low, at just half the overall rate. The prevalence of undeclared work remains a crucial issue (See Chapter 19: Social Policy and employment). Given the high unemployment rate and the annual growth rate of 1.2% in the working-age population, the labour market needs to absorb not only the unemployed but also one million new entrants every year. Overly strict employment protection discourages employers from hiring new people. Overall, the unemployment rate remains higher than pre-crisis and demographic factors are expected to keep unemployment high in years ahead in the absence of additional labour market reforms and the application of an appropriate combination of flexibility and security.

Annual inflation was 6.3% in 2009. A combination of several unfavourable developments, such as price increases for unprocessed food and oil, base effects and administered price rises, has led to a significant increase in inflation since the last quarter of 2009. These factors pushed headline inflation significantly above the central bank target, leading to an adverse impact on inflation expectations. Between November 2009 and April 2010, inflation rose from 5.1% to 10.2% before falling to 8.3% in August, reflecting large volatility in food prices. The central bank expects inflation to fall towards the end of 2010, although it is unlikely to reach the central bank end-year target of 6.5%. Core inflation went up from about 3% in mid-2009 to 4% by August-2010. Turkey's real policy rate is now low given the robust economic recovery. Cuts in the policy rate were transmitted to market rates, but at

speeds and pass-through rates that varied across instruments. Rates on corporate lending declined the most, by more than 15 percentage points. Recovering domestic demand and easing lending standards in the second half of 2009 helped revive credit supply which accelerated further to an annualized rate of around 30% in the first half of 2010. The Turkish central bank is looking ahead to a period of strong growth and has announced plans to roll back the extraordinary measures put in place during the economic crisis in 2009 and to inject less liquidity into the market and currency reserves requirements have been increased. The operational structure of the central bank's liquidity management has been changed in order to ensure a better allocation of liquidity within the banking system and to reduce the dependence of banks on the central bank's lending facilities. Taking into account its reading of the – not yet closed – output gap (according to estimates by the central bank), the Monetary Policy Committee has indicated that the monetary tightening/exit strategy should be prudent and slow. Overall, price stability worsened, chiefly because of pressures stemming from energy and food inputs and buoyant economic activity, triggering a tighter monetary stance.

Turkey's fiscal consolidation over the past decade was very significant as, in the wake of the 2001 financial crisis, the government managed to cut the public debt to GDP ratio from a high of over 70% in 2001 to less than 40% by mid-2008. Structural loosening as well as cyclical factors weakened the fiscal balance from mid-2008 to mid-2009. The deterioration in public finances accelerated as fiscal measures to stimulate economic growth, equivalent to about 5% of GDP over the period 2009-2011, were taken to minimise some of the adverse effects of the crisis. They appear to have successfully propped up private consumption and are being phased out gradually. But they also caused the budget deficit to soar from 2.2% of GDP in 2008 to about 5.7% in 2009. So far, the budget performance has improved in 2010. Budget realisation in the first six months of 2010 was much better than anticipated, as strong consumption is leading to higher tax revenue performance (up 20% year-on-year). Tax increases also contributed (VAT and special consumption taxes on, amongst others, cars and white goods had previously been lowered to prop up consumption). Subsequently, in the first half of the year, the budget deficit declined significantly to only about half last year's. The exit strategy was less visible on the spending side, as real expenditure remained at the same level as in 2009. There are signs that pressures in some expenditure categories are building up (mainly personnel expenditure and capital spending). The public debt stock rose by around 6% year-on-year to less than 45% of GDP in mid-2010. According to the government, public debt should drop to the low 40s by the end of 2010, and subsequently continue to fall slowly. With an election scheduled in 2011, however, the fiscal picture could change. Overall, although the anti-crisis measures have cushioned the economic downturn, they must be exited in a timely fashion and targeted in order to lay the foundations for strong, sustained and balanced growth.

The Public Financial Management Law was supposed to be implemented between 2007 and 2010 and to make Turkey's public finance administration broadly consistent with EU standards on internal controls. However, three years after the adoption of the law, the accountability, efficiency and transparency of the budgeting process would benefit from a modernisation of the public audit, while the adoption of the draft Turkish Competition Authority Law would contribute to less opacity on state aids in public finances. The unification of all tax administration functions under the Revenue Administration announced earlier has not been implemented in full. This unification would strengthen the audit capacity and facilitate greater use of standard risk-based audit techniques, thereby enhancing transparency and providing significant support for reducing informality. Overall, measures to increase fiscal transparency were modest.

Over the last few years, Turkey had successfully implemented a strong stabilisation programme and the resilience of the Turkish economy had benefited from in-depth structural reforms in many key areas, including banking, restructuring of enterprises and privatisation, education and energy. Although the financial crisis has hit the Turkish real economy hard, the earlier regulatory and supervisory reforms have paid off and growth resumed rapidly and strongly. Turkey's fiscal and monetary policy mix proved successful during the crisis and adjustments are being made in order to

benefit from the recovery. A new draft law establishing a fiscal anchor that has potential for considerably improving the fiscal performance over time, as well as removing the current pro-cyclical bias of fiscal policy, was submitted to parliament in mid-July, but its discussion was postponed. Making more progress with fiscal transparency, strengthening the inflation targeting and preserving financial stability will be important to minimise the risks of a boom-bust scenario. Overall, although the current policy mix has proved effective in recent months, macroeconomic stability remains vulnerable and could benefit from a stronger fiscal anchor.

### **Interplay of market forces**

The government has confirmed the independence of the regulatory and surveillance agencies. But despite the regulatory framework, government authorities still tend to set the prices in some key areas, including in electricity and gas markets, and to a lesser extent in telecommunications and transportation, in particular in rail transportation. Liberalisation of backbone services has advanced significantly and prepared the ground for several successful privatisations in the energy sector. Indeed, Turkey continued its privatisation efforts in a more challenging and crisis-prone environment. Total privatisations completed decreased from €4.4 billion (1% of GDP) in 2008 to €1.6 billion (0.4% of GDP) in 2009. A total of 106 transactions were completed in 2009. Ongoing major privatisations include the transfer of operating rights for 52 small-scale hydropower plants plus the privatisation of four sugar companies, electricity distribution in 13 regions and three ports. Overall, some progress has been made on improving the interplay of market forces. Privatisation has advanced, albeit at a slower pace due to the worsening external environment.

### **Market entry and exit**

In 2009, the economic circumstances had a major impact on market entry and exit. The number of newly established firms decreased by 10%, while the number of firms which were closed down increased by 8.5%. Foreign owners still face restrictions in various areas, including maritime transport, civil aviation, ground-handling, road transport, radio and TV broadcasting, energy, accountancy and education. Licensing procedures are relatively lengthy. For example, 25 different procedures are still needed in order to build a warehouse, from securing licences and permits to completing the necessary notifications and inspections and obtaining utility connections. Market exit is difficult too, as closing a business still takes 3.3 years on average. Moreover, claimants recover only one fifth of their claims from insolvent firms. Overall, market exit procedures remain relatively cumbersome. The crisis had a negative impact on the number of newly established firms.

### **Legal system**

Turkey has established most of the legal framework of a market economy, but must ensure further implementation. A reasonably well functioning legal system, including in the area of property rights, has been in place for several years. Registering a property requires six procedures and takes six days in Turkey. However, enforcing commercial contracts remains a lengthy process, which involves 35 procedures and takes 420 days on average. The specialisation of commercial court judges is insufficient, leading to lengthy court proceedings. The expert witness system still functions as a parallel judiciary system, without improving the overall quality. Use of out-of-court dispute-settlement mechanisms remains low. Overall, the legal environment, in particular court procedures, continues to pose practical challenges and create obstacles to a better business environment.

### **Financial sector development**

The banking sector has shown resilience to the global financial crisis, largely due to major improvements made to the regulatory and supervisory framework in previous years. Risk ratios in the financial sector remained robust. The sector also benefited from the central bank's liquidity measures



and some easing of regulations governing loan classification and provisioning requirements. In a crisis context, a temporary easing of conditions for restructuring loans and a temporary elimination of general provisioning for new loans aimed at preserving the banks' high capital adequacy ratios while encouraging lending. These measures helped the nominal capital adequacy ratio to increase to almost 20% by early 2010, substantially higher than the EU legal requirement of 12%. Non-performing loans fell to about 5% by mid-2010 from a peak of about 6% at the end of 2009 and stress tests by the regulator show that the sector is sound. The banking sector, by far the largest part of the financial sector, increased its share to 78% of the total financial sector. The relative size of the insurance sector increased slightly to 3%, about the same size as mutual funds. Domestic private banks had a 32.5% share of total assets, whereas the share of foreign banks increased to 39.5%, taking into account foreigners' investments in the stock exchange, which is equivalent to 20% of banking sector assets. The Istanbul Stock Exchange increased considerably during 2009, with total stock market capitalisation almost doubling, from 19% of GDP in 2008 to 37% in 2009 and over 40% of GDP by mid-2010. Concentration in the banking sector remained broadly stable, as the shares of the top five and top ten banks were 60% and 80%, respectively. However, due to the very strong ongoing credit growth fuelled by increased consumer and business confidence and low interest rates, regulatory authorities need to remain vigilant. Overall, in difficult crisis conditions, the financial sector has shown resilience thanks to earlier reforms.

#### **4.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

##### **Existence of a functioning market economy**

The strength of domestic demand is fuelling a fast recovery from recession, which confirms the economy's improved shock resilience. But it is also fuelling rapid expansion in the current account deficit, pointing to the return of persistent imbalances in the Turkish economy. As the recovery gets under way, a golden opportunity for structural reforms is being opened up by the sharp drop in real interest rates in recognition of Turkey's solid fundamentals. At the same time, potential growth in Turkey is being held back by high inactivity and insufficiently broad-based productivity growth. Overall, the crisis did not jeopardise the functioning of market mechanisms.

##### **Human and physical capital**

The educational reform programme, which is a key part of the National Development Plan (2007-2013), is being implemented. It sets two key priorities for education, modernisation and reform: increase the responsiveness of education to demand and enhance the educational system. In 2010, the challenges remain significant. Although there has been some progress and the top students in Turkey are performing well, the vast majority of Turkish students perform at the lowest proficiency levels in basic skills and problem-solving. Participation in higher education remains low by international standards. Around 44% of 20- to 24-year olds go to university, 8 percentage points more than in 2006, while only 1.5% of school-age children fail to finish primary school, compared with 10% in 2006. Overall, reforms and increased spending on education are obviously having some positive impact on educational attainment, but significant problems persist.

During the crisis, investment decreased and gross fixed capital formation (GFCF) fell by around 3% in 2009 to about 20% of GDP, but growth resumed by as much as 22% in the first half of 2010. Private capital formation totalled around 15% of nominal GDP. FDI inflows held up relatively well in 2009 helped by the privatisation of the electricity grids but fell by about 20% in the first half of 2010 compared with a year earlier. At the same time, their composition improved, as more than three quarters went into utilities and manufacturing. For many years infrastructure investment has been hampered by the need to consolidate public finances and the failure to cut lower-priority spending.

Inadequate infrastructure is increasingly affecting economic activity. Though in 2009 and 2010 some – albeit modest – progress can be reported on infrastructure, in particular roads and oil pipelines, there is a risk that inadequate infrastructure, including for power supply, could hamper the economic recovery. Gross electricity consumption growth has averaged some 7% in each of the last few years, and extra power-generating capacity is being constructed, albeit with some delays. Although the official government target was to increase research and development expenditure to 2% of GDP by 2010, R&D expenditure remains much lower, on just 1.4%. Overall, some limited progress was made on upgrading the country's human and physical capital.

### **Sectoral and enterprise structure**

The independence of the regulatory and surveillance agencies has been largely preserved. Market liberalisation has not advanced in agriculture, whereas some progress has been made in the pricing mechanisms for the energy sector. The sectoral shift from agriculture to services and industry was reversed by the slowdown in economic activity. The share of agriculture in overall employment increased from 23.7% to 24.7% between December 2008 and December 2009. The share of services stabilised at 50%. On the other hand, both industry and construction saw their relative shares of total employment decline by a combined total of 1.5%. The quality and frequency of data on small and medium-sized enterprises (SMEs) remained poor. Various new initiatives have been launched to improve access to finance for SMEs. However, the share of SMEs in total banking sector loans decreased from 23% at the end of 2008 to 21.4% by December 2009. For instance, a new guarantee fund for SMEs was part of the stimulus packages with the aim of alleviating the impact of the crisis on SME finances. But the earmarked funds of €500 million were underutilised, as only seven SMEs had received credit guarantee support by 31 March 2010. The large informal sector which is fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, remains an important challenge. Turkey therefore adopted a comprehensive action plan to combat the informal economy in 2009. Overall, the crisis slowed down or even reversed structural shifts in economic activity. In spite of new initiatives by the Turkish government, the crisis has complicated access to finance for SMEs.

### **State influence on competitiveness**

There has been no tangible progress in the field of state aid. As transparency in the decision-making process remains low, it is still difficult to judge the rationale and consistency of the individual decisions taken. In addition, the scale of state aid and its importance in some key sectors are likely to have increased substantially following the introduction of the various fiscal stimulus packages. Adoption of the commercial code has again been postponed. The absence of transparent monitoring of state aid and of supporting policies to reduce distortion continued to have an adverse effect on competition and competitiveness in the economy. Public procurement policies continued to be undermined by exceptions to the regulatory framework. Overall, state intervention continued to be untransparent, which might have had a negative effect on competition and competitiveness.

### **Economic integration with the EU**

The openness of the Turkish economy, as measured by the total value of exports of goods and services as a percentage of GDP, decreased to about 47.5% of GDP by the end of 2009, from 52.2% in 2008, largely in line with the crisis-led contraction in world trade. The EU's share of Turkey's total trade increased from 41.4% in 2008 to 42.6% in 2009. Its share in Turkey's exports decreased from 48% in 2008 to 46% in 2009. While the EU's share of Turkey's trade varies slightly from year to year, depending on numerous factors, including commodity price trends and exchange rate movements, its decline in Turkey's exports is likely to be the result of relatively more subdued demand in the EU. Simultaneously, Turkey was somehow able to diversify its exports towards other regions. The share of exports to African and Middle East countries in Turkey's total exports increased from 10% in 2008 to over 20% in 2009. FDI inflows to Turkey from EU Member States remained very significant, growing

from 75% of the total in 2008 to 80% in 2009, thus illustrating the strong economic interdependence between the EU and Turkey. Overall, trade and economic integration with the EU remained high. Turkey was able to diversify part of its trade towards new markets, thereby partly alleviating the impact of the crisis.

Incipient nominal exchange rate appreciation pressures were observed in the first half of 2010. In the year to July 2010, the exchange rate for the lira appreciated by 5% in nominal terms against a basket of 50% US dollar and 50% euro. In real effective terms, corrected for both producer and consumer price developments, the lira strengthened by 8%. Overall, standard indicators suggest that Turkey's export competitiveness has stopped improving.

### 4.3. Conclusions

The Turkish economy was hit hard by the global financial crisis, but quickly recouped its losses, as it started growing across the board at robust rates since the second quarter of 2009. The government budget and the central bank have successfully provided substantial support for aggregate demand, particularly via a significant easing of the fiscal and monetary stance. High growth rates are accompanied by rapidly widening trade and current account deficits, falling unemployment – though still higher than pre-crisis levels - and rising inflationary pressures. The exiting strategy from crisis-related intervention policies focuses on achieving strong, sustained and balanced growth. The design of a fiscal rule has been completed and has the potential of considerably improving the fiscal performance over time. However, its adoption by the Parliament has been delayed. Progress with respect to structural reform was mixed, but lower real interest rates and stronger economic fundamentals should provide scope for an acceleration of structural reforms.

As regards the economic criteria, Turkey is a functioning market economy. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided that it continues implementing its comprehensive structural reform programme.

In the aftermath of the crisis, consensus on economic policy essentials has been preserved. The anti-crisis measures have cushioned the economic downturn although they have increased Turkey's fiscal deficit and debt stock. They are being phased out gradually. A timely, targeted and well anchored withdrawal of the stimuli remains a challenge in order to maximise the benefits from previous years of fiscal consolidation and overall medium-term fiscal sustainability, and to achieve strong, sustained and balanced growth. Privatisation has advanced, albeit at a slower pace due to the global economic environment. The financial sector has shown remarkable strength thanks to earlier reforms. Investment picked up strongly and some limited progress was made in upgrading the country's human and physical capital. Turkey was able to partly diversify its trade towards new markets, thereby alleviating to a certain extent the impact of the crisis. Trade and economic integration with the EU remained high.

However, external imbalances and financing needs have been growing significantly on the back of resuming growth and although access to external finance remained unproblematic. Inflationary pressures increased considerably, chiefly because of pressures stemming from energy inputs and buoyant economic activity. Making more progress with fiscal transparency, strengthening the inflation targeting framework and preserving financial stability remain key conditions in order to minimize the risks of a boom-bust scenario. The unemployment rate remains higher than its pre-crisis levels and demographic factors are expected to keep unemployment high in coming years. The low capacity to create new jobs is clearly linked to a skills-mismatch between labour demand and supply, as well as excessive labour market regulation. There are obstacles to market exit and bankruptcy proceedings are relatively cumbersome. The crisis has further complicated the access of SMEs to finance. The legal environment, and in particular court procedures, continue to pose practical challenges and create obstacles to a better business environment. The current product market regulation and the persisting

lack of transparency on the allocation of state aids are not conducive to improving the business climate. The informal economy remains an important challenge.

## 5. ALBANIA

In 1993, the European Council in Copenhagen set the following economic criteria for accession to the EU:

- the existence of a functioning market economy;
- the capacity to cope with competitive pressure and market forces within the Union.

These criteria are linked. A functioning market economy will cope better with competitive pressure and, in the context of membership of the Union, the reference market is the internal market.

Following a brief overview of economic developments and policies in a historical perspective, the report goes on to consider the extent to which Albania fulfils the two economic criteria established by the Copenhagen European Council.

### 5.1. ECONOMIC DEVELOPMENTS

Albania is a small and mountainous country, with a population of just over 3 million distributed on a territory of 28,750 square kilometres. The country is well endowed with natural resources, mainly chrome, nickel, copper, and small quantities of oil and coal. Albania enjoys a favourable climate for agriculture and tourism and almost all of its electricity needs can be generated from hydropower sources. Albania has undergone a profound structural transformation over the past two decades, from a highly centrally planned to a free-market economy, which has resulted in high growth rates. Average annual GDP growth was slightly more than 6% from 2000 to 2008, before slowing down to just over 3% in 2009. Gross domestic product reached almost €9 billion (2009), or 0.07% of EU-27 GDP. Expressed in purchasing power standards, GDP per capita in 2009 amounted to €6,400, or 27.1% of the EU-27 average. Income disparities between Tirana, the capital, and the less developed mountain areas are significant, but declining,

#### Macroeconomic background

The first years of the transition that started in 1991 saw a drastic contraction in output, a ballooning budget deficit and inflation rising to triple digits. With the support of the international community, in 1993 the country embarked on a programme to stabilise the economy that included fiscal consolidation, tight monetary targets and structural reforms. Progress towards macroeconomic stability was interrupted in 1997 by the collapse of the so-called pyramid schemes which had a significant adverse effect on the economy and gave rise to civil disorder. The opening of the country and the collapse of the pyramid schemes also resulted in mass emigration and workers remittances have become an important feature of the Albanian economy.

In the aftermath of the pyramid schemes crisis, a new stabilisation programme was launched. This programme led to a notable improvement in economic performance in 1998 and in subsequent years, underpinned by gradual fiscal consolidation and a tight monetary policy. By 2000, inflation had been brought down to single-digit levels. Macroeconomic stability has been broadly maintained since 2000 and steps have been taken to integrate Albania with the international economic system.

Albania has undergone significant reforms aimed to enhance the quality of public spending. Fiscal discipline improved during most of the 1990s in line with the various adjustment programmes. Since 2000, a medium-term budget programme, which consists of a rolling three-year expenditure plan, has been in place.

In the first years of transition unemployment soared, reaching its peak at 23% in 1993. It was then slowly reduced mainly due to migration. In the aftermath of the pyramid scheme crisis unemployment increased again. Since 1999 it has been progressively reduced, however, it remains high standing at 13.8% in 2009.

The moderate openness of the economy and the low level of integration of the financial system with the global market, together with the substantial, albeit declining, share of agriculture have limited the impact of the global crisis on Albania. Macroeconomic policy has been instrumental in cushioning the effects of the turmoil.

### **Structural change**

Since 1991, the economy has undergone a structural transformation which has seen a decline in the dominance of industry and agriculture in favour of services and construction. Services are now the main driver of growth, accounting for around 54% of GDP. Manufacturing is characterised by a lack of diversification, both in terms of products exported and export markets.

Privatisation featured high on the reform agenda from the early stages of transition. In the first stage, which started in 1991, small retail shops and other commercial services, agricultural land and housing were sold, mostly to their current employees. A mass privatisation programme to sell off large state-owned enterprises began in 1995 and proceeded with relative speed. Since 1999, around 340 public enterprises have been partly or fully privatised through international tendering in strategic sectors. The share of the private sector is now 82% of GDP.

Until 1991, prices at all levels of production were established by central planners. Comprehensive price liberalisation covering practically all consumer goods took place in 1992 as part of the macroeconomic stabilisation and reform programmes. The authorities also adopted a policy of gradually freeing or raising some of the controlled and administered prices to cost-recovery levels.

In 1992, the authorities embarked on a programme to establish a modern banking system. This was given a further impetus as a response to the pyramid scheme crisis. A new banking law was passed further strengthening the independence of the Bank of Albania. Steps were also taken to improve banking supervision and introduce prudential regulations. In addition, a privatisation strategy was launched and the entry of new private banks encouraged. The reforms proved effective and led to an increase in formal private sector credit and a rise in the number of private banks. With full privatisation and the entry of international private banks, the banking sector has continued to develop in recent years.

Significant progress, mainly in facilitating market entry, has led to an increase in foreign investment in recent years. However, it remains low by regional standards. This reflects a weak business climate which, among other things, suffers from incomplete recognition of property rights, shortcomings in the public administration, weak enforcement of the law and bottlenecks in basic infrastructure, including as regards the reliability of power supply.

Table 5.1:

**Albania - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	5.7	5.4	5.9	7.7	3.3	2.0*
Private consumption	Ann. % ch	8.8	7.2	13.4	9.8	N.A.	N.A.
Gross fixed capital formation	Ann. % ch	1.5	16.2	6.5	12.9	N.A.	N.A.
Unemployment	%	14.3	13.9	13.3	12.7	13.0	13.8
Employment	Ann. % ch	0.9	0.2	0.2	3.6	-1.5	-7.2
Wages	Ann. % ch	9.9	7.5	17.2	8.2	11.8	6.7
Current account balance	% of GDP	-8.9	-6.6	-10.6	-15.4	-15.1	-13.7
Direct investment (FDI, net)	% of GDP	3.2	3.5	6.0	7.0	7.6	6.1
CPI	Ann. % ch	2.4	2.4	2.9	3.4	2.3	3.9
Interest rate (3 months)	% p.a.	5.55	5.49	5.92	6.24	N.A.	N.A.
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate LEK/EUR	Value	123.73	122.76	123.31	122.39	131.82	137.67
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-3.4	-3.3	-3.5	-5.5	-6.8	-1.1
General government debt	% of GDP	56.8	56.8	54.8	53.9	59.5	N.A.

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

## 5.2. ASSESSMENT IN TERMS OF THE COPENHAGEN CRITERIA

### 5.2.1. The existence of a functioning market economy

The existence of a functioning market economy requires that prices, as well as trade, are liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of significant barriers to market entry and exit improve the efficiency of the economy.

#### Economic policy essentials

Albania has implemented far-reaching market-oriented changes, including price and trade liberalisation, privatisation and fiscal and monetary reforms. These reforms have been supported, inter alia, by several financial and technical arrangements with the EU, the IMF and the World Bank. There has been over the years a consensus between the political parties about Albania's integration with the EU. Overall, there is a broad domestic consensus on the fundamentals of economic policy.

#### Macroeconomic stability

Real GDP growth has been very strong since 1998, reflecting the continuation of resource re-allocation from low to higher productivity sectors. Consequently, Albania's per capita GDP increased but remains very low. Private consumption remains the main component, representing some 80% of GDP, reflecting the significant boost given to household income by migrants' remittances. The role of remittances in the development of the economy has been significant throughout the transition. Unlike most other countries, economic growth remained positive although decelerating to slightly above 3% in 2009, owing to the impact of the global crisis. Overall, Albania has witnessed very strong economic growth, exceeding 5% since 1998, while economic activity slowed down but remained positive in 2009 in spite of the global crisis.

Since 2000, the current account deficit has been progressively rising, mainly due to a growing merchandise trade gap. It reached 15% of GDP in 2009. After posting a deficit between 2002 and 2006, the services account turned into a surplus as exports — supported by a burgeoning tourism sector — increased rapidly. Around half of the trade deficit has traditionally been financed through

current transfers from abroad, amounting to approximately 13% of GDP in 2009. A significant share of these transfers is accounted for by workers' remittances which, after following an upward trend in the first half of the 2000s, have declined in the past few years. In the last decade, net capital inflows have broadly covered the current account deficit, contributing to higher foreign reserves. FDI, driven by privatisation proceeds and representing around half of external financing, rose from around 4% of GDP in 2000 to 7.6% in 2009. The high current account deficit represents a risk. Insufficient capital inflows, specifically FDI, could lead to an abrupt adjustment with a negative feedback loop on the real economy and an adverse impact on public finances. Overall, the trade balance and the current account show significant and persistent deficits.

The contribution of employment to GDP growth has been limited, partly due to unfavourable demographic shifts, a loss of skills spurred by mass emigration as well as a significant informal sector. Job growth was positive in the period 2002-08 but contracted in 2009 as a result of the crisis. Unemployment has been declining gradually along the years and stood at 13.8% in 2009. The labour market is characterised by a high inactivity rate, which in recent years stood at just below 40%. Informal work arrangements remain widespread across most economic activities notwithstanding several initiatives to tackle them, including a reduction in social contributions. High long-term unemployment, which accounts for around 65% of total jobseekers, is another characteristic of the Albanian labour market. Female participation and employment rates are significantly lower than for males, while unemployment is higher. Although official labour market data comprise a high degree of uncertainty, unemployment has remained persistently high reflecting the low education level, the outdated skills of the jobless and undeclared work, which help in alleviating poverty but reduce job-search incentives. Overall, the existence of widespread informal work arrangements continues to severely distort the labour market whilst the absence of reliable statistics hampers the analysis. Although declining, unemployment has remained stubbornly high.

The Bank of Albania, a largely independent institution, was mandated in 1997 to achieve and maintain price stability as a primary objective. Direct credit and administered interest rates were replaced in 2000 by repurchase agreements, which became the key policy instrument for controlling bank liquidity. In 2004, the Bank moved closer to an inflation targeting framework to achieve the price stability goal by keeping an inflation rate of 3%, within a band of +/- 1 percentage point. This publicly announced target has been instrumental in anchoring inflation expectations.

During the last decade, inflation was brought progressively down and, except for 2002, was below 3%. Inflation started to pick up in October 2009, reflecting mostly the depreciation of the lek which raised import prices. It accelerated in January and February 2010, primarily due to increases in administrative prices (water and electricity tariffs) but decelerated thereafter, reaching 3.4% in September. Overall, since 2003 annual inflation has remained below 3%, reflecting a monetary policy conducive to a high level of price stability.

The degree of euroisation in the economy is high. The high interest rate on lek-denominated loans, while essential for the stability of the currency, has resulted in more lending in foreign currencies. In July 2010, the share of foreign-currency loans amounted to 70% of the total stock of loans, while their share of deposits was 48%. Such currency substitution places a constraint on the effectiveness of monetary policy. Furthermore, the high euroisation is a potential source of financial system instability since it may expose banks to currency risk. The BoA has taken prudential measures that have the effect of encouraging borrowing in the local currency by, among other things, requesting banks to weight foreign currency-denominated loans with an additional 50% when calculating capital adequacy ratios.

The weighted average interest rate spreads between loans and deposits are relatively wide, standing at about 8.4 percentage points for those denominated in lek, but have declined significantly during the past years (from 16.5 percentage points in the last quarter of 2000).



Albania has established a loosely managed float as its exchange rate regime with the value of the currency determined in the foreign exchange market and interventions limited to softening sharp currency movements, while maintaining adequate reserve cover. With the unfolding of the global crisis, the lek started to weaken and on average lost 7.5% of its value against the euro in 2009. At the end of 2009, the BoA reserves amounted to 4.3 months of imports of goods and services. Overall, monetary policy has been conducive to anchor inflationary expectations notwithstanding the important constraint placed on its effectiveness by the high euroisation.

The government deficit which had followed a downward path until 2006, reached 7% of GDP in 2009. Until 2006, the overall improvement in the fiscal imbalance has been mainly expenditure-led, first relying on restraint of non-wage current spending and capital outlays while during the period 2000-05 the budgetary consolidation reflected primarily lower interest payments. Total revenue only rose marginally in the period 2000-06, as the notable gains in direct and indirect taxes were partially offset by lower foreign project-related aid and customs duties, due to the alignment of tariffs with international obligations. Thereafter, following an increase in 2006-08, revenue declined in 2009 and stood at 26.2% of GDP as the government allowed the full play of automatic stabilisers, mostly through lower receipts from direct and indirect taxes, in the face of weakening economic performance. Total expenditure started to rise in 2006, reaching 33.2% of GDP in 2009, driven mainly by higher capital spending — related to major road infrastructure projects — as well as an increase in the public service wage bill and pensions. This suggests that a pro-cyclical stance, masked by tax-rich revenue in the boom period, started already in 2006 and contributed to aggravating the budgetary deficit and external imbalance, leading to reduced fiscal space in the post-crisis period. Overall, the public deficit has been brought down from high levels but the trend was reversed in 2007-09, fed by pro-cyclical expenditure policies already as of 2006.

The composition of government revenue remained practically unchanged during the period 2000-09, with indirect tax revenue (VAT) representing the largest share (36.8% in 2009). As a result of the broadening of the tax base, the share of direct taxes (15.5% in 2009), particularly personal income tax, increased significantly over this period, partly owing to the lowering of statutory tax rates to 10% and the establishment of reference salaries and reference employment in 2008. While these measures help to reduce tax evasion, a fully-fledged tax compliance system is still lacking. Reforms over the years have led to improvements in the tax administration. However, gaps in terms of both revenue collection and continued administrative changes remain. In addition, corruption in tax and custom collection, as well as weak law enforcement, allow businesses to operate in the informal sector, which in turn results in a narrow tax base. The management of local government finances remains poor, resulting in low revenue collection (small business, property and local taxes for which they are responsible account for some 4% of total government revenue), and limited spending. The structure of total expenditure is dominated by current transfers (30%) and capital outlays (29%). Compensation of employees followed a rising trend over the period 2000-09, now representing roughly a fifth of total spending. Interest payments declined progressively, due to both lower interest rates and public sector borrowing requirements, but still represent some 9.5% of total expenditure and therefore continue to crowd out primary spending. Overall, weak institutions and a large informal sector have resulted in a narrow tax base which constrains fiscal receipts, despite various measures in the past years.

The fiscal consolidation brought about a decline in public debt, from 61% of GDP in 2000 to 54.3% in 2007. This downtrend was reversed in 2008-09, when the debt stood at almost 60% of GDP. While this is a relatively high public debt ratio, a risk-mitigating factor is the fact that some three-fifths of total public debt is domestic, almost entirely denominated in lek. The public debt consists of central government debt and while local governments can borrow, the use of this possibility has been limited so far. However, around 60% of domestic debt is short-term, i.e. with a maturity of 1 year and less, giving rise to refinancing risk. Commercial banks remain the main holders of domestic public debt. External debt is composed of long-term loans of which slightly more than half is denominated in euro, while another 30% is denominated in Special Drawing Rights. Multilateral creditors represent

approximately 53% of the external debt. Overall, the recently increasing and high level of public debt remains a source of macro-financial vulnerability.

Appropriate fiscal and monetary policies have been the main anchors of the policy mix and have underpinned the relative macroeconomic stability in Albania. However, the pro-cyclical budget stance since 2006 has reduced the fiscal room for manoeuvre and reversed the decline in public debt. The monetary policy framework has anchored inflation expectations, despite the limitations arising from significant euroisation. The flexible exchange rate has supported adjustment to external shocks. Overall, rebuilding fiscal space so as to ensure medium-term budgetary sustainability and vigorously accelerating reforms to continue structural adjustment remain key macroeconomic policy challenges.

### **Interplay of market forces**

Price liberalisation has been largely completed but price regulation protects a number of sectors. Around 4.3% of the items that compose the consumer price index remain administered or regulated. Administered prices are set by sectoral regulators (electricity, telephony, water supply) or government bodies.

State participation in the economy has been progressively reduced and as a consequence the private sector today accounts for around four-fifths of GDP and 82% of total employment. This has been achieved largely through a widespread privatisation process. The sectors that are still owned or controlled by the state include electricity generation, railways, ports and water supply utilities. The government is planning to continue with the privatisation programme by proceeding with the delayed selling of shares and assets in strategic sectors such as hydrocarbons, insurance, certain port services, certain operations in rail transport and telecommunications. Overall, the privatisation process is advanced, while the contribution of the private sector in the economy has reached a high level.

### **Market entry and exit**

Significant progress in facilitating business start-ups has been achieved in recent years. In 2007, a new law was approved on the National Business Registration Centre (NRC) which provides for simultaneous registration in ‘one-stop-shops’ for the purposes of tax administration, social and health insurance, and labour inspections. The streamlined procedures have made business start-up faster and cheaper. Despite an increasing number of electronic services and registration centres across the country, further efforts are required to strengthen the NRC’s capacity in municipalities. In addition, with the establishment of a National Licensing Centre (NLC) in 2009, many licences were abolished, while procedures for many sectors have been simplified and streamlined, thereby reducing administrative barriers for businesses. Overall, notable progress has been achieved in facilitating market entry at national level but more effort is needed at local level.

The new law on bankruptcy procedures approved in May 2009 provides a more efficient framework for market exit. Moreover, courts will consider a case within 30 days, thereby speeding up bankruptcy procedures. However, implementation has been poor, the agency to deal with bankruptcy cases provided for in the amended law has not been established yet, and the number of companies declared bankrupt by the courts has been minimal, despite several ongoing judicial proceedings. Overall, despite recent legislative changes, implementation of bankruptcy procedures remains largely ineffective.

### **Legal system**

A legal system which supports the market economy has been evolving since the 1990s. However, the legislative process is not fully transparent as proposed laws are not always subject to public

consultation. Laws and regulations are sometimes inconsistent, incomplete or lack implementing regulations, leading to unreliability in their interpretation.

The functioning of Albania's property market remains inefficient, which adds to business uncertainty. One of the main issues relates to the restitution of property and the regularisation of informal construction. About 80% of all property has been registered, but registration is less advanced in urban and coastal areas, the latter having a high potential for tourism development. The land registration process is tainted by lack of legal documents, delays and poor enforcement of court decisions, competing land ownership claims, corruption and weak coordination among government agencies. This leads to an informal exchange of property giving rise to disputes which further burdens the courts and causes an additional loss of tax revenue. Overall, although progress has been achieved in the past two decades, ownership transfer and recognition of property rights remain incomplete and hamper the functioning of the land market.

The judicial system suffers from undue political interference, corruption, lack of capacity and non-transparent and inefficient court proceedings. Informal methods of contract enforcement, by-passing the legal system, continue to be widespread. The government took several steps to strengthen the judicial system and step up the fight against corruption. A number of electronic public services (including the electronic public procurement system) were introduced in order to increase transparency. Inspections of courts and public agencies have been stepped up and legal proceedings initiated against officials responsible for violations. However, the law establishing the administrative courts, that will deal with commercial cases and disputes between companies and public institutions, has not been adopted. The role of courts in the enforcement of contracts remains limited due to weak administrative capacity and prevalent corruption. Overall, while some progress has been recorded, the business climate remains hampered by the weak rule of law.

### Financial sector development

Although still low, banking intermediation has increased rapidly during the past years. In 2009, the loan-to-GDP ratio rose to slightly above 41% from 7.3% in 2003. All 16 commercial banks are fully privately-owned with an asset-to-GDP ratio of approximately 82%. The banking sector is characterised by a high degree of concentration, with the six largest banks having a share of 72% for loans and 81% for deposits.

Ownership of the banking sector is foreign-dominated. The capitalisation of the banking system has increased gradually, standing at around 9.4% of banks' balance sheets. The capital adequacy ratio stood at 16.2% in 2009 — well above the legal minimum of 12% imposed by the BoA and the 8% required under the Basel framework agreement.

The structure of the banks' assets has undergone significant changes in recent years. The banking sector's investment in government securities has declined from almost half the total assets in 2003 to 12% in 2009, giving way to an increase in the share of the credit portfolio. The corporate sector share in total loans amounts to roughly 62%, households 33%, the public sector 2.7%, and financial institutions accounted for the rest. In the past seven years, the maturity structure of loans has become increasingly skewed toward long-term loans, i.e. loans with maturity of one year and above, which represent around 72% of the total.

Banks' profitability followed a general upward trend on the back of increasing net operating income between 2004 and 2007, but declined in the subsequent two years owing mainly to rising operational costs and the rapid growth of expenses for provisioning due to the economic crisis. While non-performing loans (NPLs) increased at a moderate pace in the period 2005-07, this pace has accelerated since the last quarter of 2008. In the first half of 2010, NPLs continued to increase — reaching 12% in

the second quarter of 2010 — although at a decelerating pace. Return on assets dropped from 1.3% in 2004 to around 0.3% in 2009. However, the banking system remains well capitalised.

Starting from a low base, credit expanded rapidly in the first half of the 2000s, driven mainly by heightened competition in the sector following the privatisation of the Savings Bank. Most of this expansion in lending was financed through domestic resources, in the form of domestic deposits and recapitalisation. During the past two decades, the Bank's supervisory capacity has been significantly bolstered through the implementation of a more risk-based supervision process. Substantial progress has been made in improving the legal framework for insolvency and bankruptcy procedures have been strengthened. Overall, the banking system has recorded rapid expansion in recent years as a result of privatisation and the entry of foreign players.

The insurance market has registered gradual expansion, albeit from a low base. In 2008, total assets amounted to approximately 1.4% of GDP. All 10 licensed companies active in the sector are domestic, but since 2007 Albania has attracted increased foreign (EU) participation. In the voluntary insurance sector, non-life insurance represents around 83% of turnover. The private pensions market is still underdeveloped. Three companies are licensed to offer private pensions. At the end of 2009, the legal framework for private pensions was amended by a new law on voluntary pension plans. The law opens up the possibility for the establishment of defined contributions third pillar pension funds, but does not reflect all the provisions of the *acquis*. Overall, the non-banking financial sector is still undeveloped and plays a negligible role as a source of private sector financing.

The Tirana Stock Exchange was formally established in 1996, but there are no companies listed on the stock exchange.

#### 5.2.2. Capacity to cope with competitive pressure and market forces within the Union

The ability to fulfil this criterion depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to take decisions in a climate of predictability. It also requires a sufficient amount of human and physical assets. Enterprises need to invest to improve their efficiency and innovate to adjust to a globalised and highly competitive external environment. Overall, the more an economy is integrated with the Union before accession, the better will it be able to take on the obligations of membership.

#### **Existence of a functioning market economy**

Albania is a small and increasingly open economy with a large private sector that accounts for some 80% of GDP. Prices and trade have been mostly liberalised. Throughout the transition, Albania has broadly followed a policy mix pursuing macroeconomic stability. Economic growth has been strong while inflation has declined and remained low. However, the current account deficit has worsened throughout the years, while unemployment, although declining, remains high. The pro-cyclical expenditure stance, which started already in 2006, led to a rise in the budgetary deficit as of 2007 and was further aggravated by deteriorating revenue in 2009. As a consequence, the decline in public debt was reversed, which, together with the build-up of external imbalances, poses a risk to macroeconomic stability. Resuming fiscal consolidation, bolstering the stability of the banking sector, eliminating obstacles to market entry and exit and stepping up the enforcement of the legal system would improve the economy's growth potential. Overall, Albania has achieved a degree of macroeconomic stability which broadly allows economic operators to make decisions in a climate of predictability. However, to become a functioning market economy, Albania needs to further strengthen governance, improve the performance of the labour market, complete the recognition of property rights and step up law enforcement.

## Human and physical capital

Although public resources devoted to education are significant (3.8% of GDP in 2009), Albania faces a number of challenges. Demographic shifts brought about by the brain drain in the past years, a high incidence of informality as well as weaknesses in the education and skills system hinder the full realisation of human capital. The result is that firms face a dearth of skills that limits their growth. Educational attainment is weak notwithstanding improvements in the past years. On average, Albanian pupils complete 8.6 years of schooling, which is significantly low by international standards. However, drop-out rates have fallen in recent years, especially in primary education, and participation in secondary and higher education have increased. Reforms to make the vocational education system (VET) more responsive to changes in the labour market are relatively recent. University curricula, which were insufficiently linked to labour market demand, are undergoing a thorough re-organisation in terms of content and structure in accordance with the Bologna standards. On an institutional level, reforms are also increasing the autonomy and self-governance of universities. The level of expenditure on research and development in Albania remains low. Spending on scientific research was estimated at 0.2% of GDP in 2009. Overall, while there are serious gaps in the knowledge, skills and orientation of the labour force needed by a changing job market, recent reforms are a step in the right direction.

In 2007, a strategy on employment and vocational training covering the period 2007–13 was adopted. The National Employment Service runs active labour market programmes by providing vocational counselling and training and job mediation and employment promotion programmes mostly targeting students, females and vulnerable groups. The coverage of these programmes remains inadequate. A comprehensive strategy on workforce skills is lacking, while on-the-job training is weak. Overall, active labour market programmes are insufficient compared with the level of unemployment, while work-related training remains a challenge.

Burdened by a largely obsolete physical capital stock, Albania faced considerable investment needs after 1992 in view of its very poor endowment with basic infrastructure and productive capital. Expressed as a percentage of GDP, average annual total investment amounted to around 37% during the period 2000-08. However, residential property, which saw rapid expansion during the past years sustained by strong inflows from migrants' remittances, accounted for most of this high level of investment. Such investment, together with rather modest green-field inward investment which has been concentrated in capital-poor manufacturing activities in the past years, is unlikely to increase the economy's productive capacity. Green-field investment is hampered by the state of infrastructure which, although improving in the last two decades, still faces weaknesses in terms of quality, reliability and affordability. Overall, investment has been high but impediments to productive capital remain.

The unreliability of electricity supply is one such constraint. Lack of investment in the transmission and interconnection grids as well as over-reliance on hydropower has led to periodic load-shedding. This, together with deficiencies in distribution, translated into financial losses for KESh, the power supplier, triggering the need for subsidies. However, the situation has improved since 2008 mainly because of favourable hydrological conditions. In 2003, a national energy strategy was launched with the objective of transforming the sector along market-oriented principles. The government is seeking to diversify energy sources by offering concessions to private investors for the construction and operation of hydroelectric plants and other alternative sources of power. Interconnection with neighbouring countries is limited, although investment in this area is ongoing. Overall, recent reforms have begun to address the bottlenecks in electricity infrastructure but further investment is needed to ensure a reliable supply.

Telecommunications infrastructure is also inadequate and hampers businesses. Fixed-line telephone penetration stands at a low 11.3 per 100 inhabitants. Broadband penetration remains significantly low at 2.5% of population as tariffs remain high. Internet take-up by business has increased in recent years

but remains particularly low among micro-enterprises that comprise the largest proportion of firms. On the other hand, heightened competition has led to a rapid rise in mobile telephony density, which is comparable with EU levels. Notwithstanding the competition and reductions in tariffs in 2008, mobile telephony charges remain at the high-end by regional standards. Overall, the performance of telecommunications is weak.

Significant investment in recent years has resulted in an enlarged road network but the incidence of poor quality roads is high since spending allocated for road maintenance is low. Albania's primary deep-sea ports in Durres and Vlora are undergoing upgrading works. The priority given by the government to road infrastructure has resulted in a lack of investment in the rail network. Overall, attention devoted to building transport infrastructure in the past years has not been matched with maintenance, while rail transport remains inadequate.

### **Sector and enterprise structure**

Most of manufacturing is classified as light industry and is almost entirely privately owned. Despite a notable expansion in recent years, Albania's manufacturing base remains narrow and capital-poor. The textiles and footwear sub-sectors is a major sub-sector, representing some 15% of industry value added. A large part of output is destined to foreign markets and constitutes around 43% of total export of goods. The extracting sector, composed of energy and non-energy production, represents around 14% of merchandise exports. The non-energy sector is composed of mining of metal ores and other mining. Given Albania's significant deposits, the non-energy subsector remains largely below potential mainly as a result of poor institutions, a lack of regulatory effectiveness and weak technical capacities. Services represent some 54% of GDP with trade, hotels and restaurants accounting for the largest share. Tourism has been one of the most dynamic sub-sectors in the past decade.

The significantly higher share of services in output is not mirrored in employment figures. The Albanian private sector economy is characterised by a dichotomy; a high proportion of employment (around 44%) is engaged in declining sectors, primarily agriculture, with a low share of output, while growth sectors i.e. services, industry and construction with a high proportion of GDP account for a lower weight of employment (38%). The public sector absorbed roughly 18% of total employment in 2008. The informal sector, fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime, is large. It reduces the tax base and the efficiency of economic policies. Overall, despite sizeable structural shifts over the years, there is still ample scope for more labour inputs to move from low to the higher productivity activities. The informal sector is an important challenge.

In recent years, regulatory reforms provided for the restructuring and the gradual liberalisation of the electricity market as well as promoting regional trade in electricity. The government also decided to unbundle, commercialise the electric power provider and in 2009 privatised the electricity distribution arm. The sector's regulator was strengthened and given more powers including issuing licences to the different market operators. Tariffs have been gradually increased but are not yet at a cost-recovery level. Strengthening the technical, financial and management situation of the provider and making the privatisation effective by, amongst others, taking steps to reduce energy losses and enforce bill collection remain a challenge. The essential elements of the telecommunications regulatory framework are in place, i.e. a telecoms regulator and a privatised fixed-line operator, while legislation is partly in line with EU practise. Overall, recent steps in the electricity sector are in the right direction but need further re-enforcement to ensure that the re-organisation of the sector is effective.

Albania's transition process has resulted in a business sector dominated by SMEs which have a share of more than three-fifths of GDP and employ around four-fifths of total workers. Micro and small enterprises dominate the services and trade sectors, while medium-sized firms are concentrated in construction and industry. SMEs concentrate on the domestic market and lack export competitiveness.

Support to export-oriented and innovative companies is weak. In 2007, the government established a €1.6 million export guarantee fund to export-oriented firms as well as a grant scheme as part of a competitiveness fund. A strategic framework for SME development was launched in 2007 with the Business and Investment Development Strategy which is a long-term strategy complemented by a medium-term programme. Overall, SMEs are mostly domestically-oriented as export promotion remains inadequate.

Although access to finance has improved over the years, own resources remain the main source of financing for most firms. This is particularly the case for micro, small businesses and start-ups, which face tough borrowing conditions, especially in rural areas. Since 2009, credit conditions for SMEs have become more restrictive, with lending rates charged by commercial banks on new lek-denominated loans standing at around 15%. While companies continue to suffer from delays in the reimbursement of overpaid VAT or export refunds, the situation has improved somewhat since the beginning of 2010. A public credit registry, established by the BoA in 2008, collects data from banks and makes them available to lenders. However, the exclusion of micro-credit institutions from the credit registry is considered to be a bottleneck for the access to bank lending for SME. Overall, despite significant progress, access to finance remains a challenge to micro and small enterprises.

#### **State influence on competitiveness**

State aid (including for agriculture and fisheries) has declined from 0.6% of GDP in 2006 to 0.4% in 2008. Three-fifths of state aid is granted to support special sectors mostly providing public services including water supply and railways. The electricity sector has been a major recipient of state support in 2007 partly as a result of adverse weather conditions which led to a crisis in the sector. The level of subsidies granted to this sector has declined thereafter. No additional specific financial assistance was awarded to companies to counter the economic crisis in 2009 and 2010. Overall, the amounts of state aid are limited..

#### **Economic integration and convergence with the EU**

During the past two decades, Albania has become more integrated into the global economy and increasingly more open as trade in goods and services reached more than 80% of GDP in 2009 — almost double the corresponding figure in 1996. The EU is the major trading partner, representing roughly 70% of goods, followed by the CEFTA countries (9.4%). In 2008, the largest share of merchandise trade with the EU was directed to Italy (62% exports; 27% imports) and Greece (9% exports; 15% imports). However, the share of trade with both Italy and Greece has shown a generally declining trend. The increased integration and trade openness was achieved against a background of FDI inflows averaging 4.7% of GDP during the period 2003-08. During this period, more than three quarters of FDI originated from EU countries, with Greece being the main source, accounting for more than half of the total, followed by Italy (11%) and Austria (8%). Although the real effective exchange rate has depreciated since mid-2008, contributing to an improvement in price competitiveness, limited quality upgrading of exports points to weak non-price competitiveness. Overall, trade and investment integration with the EU is high. The recent depreciation of the real exchange rate has supported price competitiveness, but structural factors constrain non-price competitiveness.

### **5.3. CONCLUSIONS**

As regards the economic criteria, Albania has achieved a certain degree of macroeconomic stability. However, to become a functioning market economy, as set out by the 1993 Copenhagen European Council, Albania needs to further strengthen governance, improve the performance of the labour market, ensure the recognition of property rights and strengthen the rule of law. In order to enable it to

cope over the medium term with competitive pressure and market forces within the Union, Albania needs to strengthen its physical infrastructure and human capital and pursue further structural reforms.

There is a broad consensus in Albania on the fundamentals of economic policy as well as a track record in the implementation of economic reforms. Albania achieved a degree of macroeconomic stability sufficient enough to allow economic operators to make decisions in a climate of predictability. The macro policy mix in the past years has been appropriate, generating growth rates exceeding 5% and activity, although slower, remained positive in 2009 despite the crisis. Inflation has remained low. The free interplay of market forces has been developing through privatisation. Prices and trade have been mostly liberalised. Notable progress has been achieved in facilitating market entry. The banking system has rapidly expanded as a result of privatisation and the entry of foreign players. State aid has been reduced. The share of trade and investment integration with the EU remained high.

However, fiscal consolidation has been reversed recently and the high level of public debt remains a source of macro-financial vulnerability. A narrow export base and public investment have led to a significant and persistent current account imbalance. The existence of widespread informal work arrangements continues to severely distort the labour market and unemployment remains high and stood at 13.8% in 2009. Access to finance remains a challenge to small enterprises. Weaknesses in the rule of law hamper the business environment and ownership transfer and recognition of property rights remain a serious problem. The education system remains unable to equip the labour force with the skills needed by the changing job market. Infrastructure requires further investment. Ensuring the reliability of power supply as well as the financial viability of the electricity sector call for further attention. The informal economy remains an important challenge.



## 6. BOSNIA AND HERZEGOVINA

In examining the economic developments in Bosnia and Herzegovina, the Commission's approach was guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

In January 2010 the authorities submitted their fourth Economic and Fiscal Programme for 2010-12. The macroeconomic framework presented is more realistic than in the previous year, but still on the optimistic side. The programme remains fragmented and does not reveal a coherent formulation of economic and fiscal policies. It is not fully integrated into budgetary procedures and its objectives are not adequately quantified or backed by concrete policy measures. The implementation of fiscal adjustment and structural reform measures agreed with the International Monetary Fund in the 2009-12 Stand-By Arrangement has been broadly satisfactory. The conclusions of both the first and the second programme review were delayed due to the slow implementation of structural benchmarks, in particular in the Federation of Bosnia and Herzegovina. In April 2010 the World Bank approved a Development Policy Loan to the country that is linked inter alia to transformation of the predominantly rights-based system of social benefits into an increasingly needs-based system. The Fiscal Council failed to adopt the global fiscal framework 2011-13 within the deadlines prescribed by law, reflecting the lack of consensus between the entities and the state on economic and fiscal policy. The Fiscal Council has not met for several months. No progress has been made in the development of fiscal surveillance mechanisms based on fiscal rules, a European Partnership priority. The quality of public spending has remained low. Overall, the commitment to structural reforms and sound public finances remained uneven across the country. Some fiscal and structural reform measures have been enacted recently under the pressure of budgetary imbalances and the international support programmes.

#### Macroeconomic stability

In 2009, the country endured recession with real GDP dropping by 2.9% after a 5.7% increase in 2008. The economic downturn was mainly caused by a drop in private domestic consumption, falling investments and a contraction of external demand. Trade slowed drastically, construction activity and industrial production decreased in 2009 and unemployment picked up. Per capita income, measured in purchasing power standards (PPS), was 30% of the EU-27 average in 2009, unchanged from a year earlier. As sufficient fiscal space had not been created in the years prior to the crisis and high spending commitments prevailed, public finances came under severe stress when revenues declined in 2009 as a result of the economic contraction, so that the Bosnian authorities had to resort to the international community for external support. The fiscal adjustment measures agreed with the IMF and the World Bank for the 2009 and 2010 budgets contributed to a consolidation of public finances, while some important structural reforms have been advanced. In 2010 some signs of economic recovery can be noted as the volume of industrial production grew by 1.1% year-on-year in the first eight months and that of exports by 28.8%. Overall, available indicators suggest a mild recovery of the economy in 2010 after the recession of 2009.

The current account deficit fell from 14.4% of GDP in 2008 to 6.8% in 2009, driven mainly by a significant improvement of the trade balance due to a contraction of domestic demand which outpaced the contraction of external demand. Hence, the trade deficit fell by 29%, shrinking from 38.2% of GDP in 2008 to 27.8% in 2009 (goods only). While exports fell annually by 17.6%, the drop in imports was even steeper at 24.2%. The surpluses in the other components of the current account all

declined. Remittances dropped by around 20% but, nevertheless, transfers still represent the major offset to trade within the current account. The current account deficit was mainly financed by new loans from abroad and, to a lesser extent, by foreign direct investment.

*Table 6.1:*  
**Bosnia and Herzegovina - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	3.9	6.1	6.2	5.7	-2.9	N.A.
Private consumption	Ann. % ch	10.0	4.5	10.8	10.3	2.0	N.A.
Gross fixed capital formation	Ann. % ch	20.9	-9.4	38.3	16.7	-20.1	N.A.
Unemployment	%	44.7	44.2	42.9	40.6	42.7	42.9
Employment	Ann. % ch	0.8	2.3	4.4	2.7	-2.8	-2.9
Wages	Ann. % ch	6.1	9.6	9.8	16.6	8.2	0.5
Current account balance	% of GDP	-17.1	-8.0	-10.7	-14.4	-6.9	-5.7
Direct investment (FDI, net)	% of GDP	5.6	6.2	13.5	5.0	1.5	-0.4
CPI	Ann. % ch	4.3	6.1	1.5	7.4	-0.4	2.1
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	N.A.	N.A.	4,330	2,251	1,038	1,010
Exchange rate BAM/EUR	Value	1.95	1.95	1.94	1.94	1.94	1.93
Nominal eff. exchange rate	Index	100.0	99.7	100.3	100.1	96.3	96.6*
General government balance	% of GDP	2.4	2.9	1.2	-2.2	-4.4	N.A.
General government debt	% of GDP	25.4	21.2	18.2	17.2	21.8	N.A.

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

The trade balance continued its improvement in 2010 and the deficit fell by 10% year-on-year (January-August). Unlike in 2009, this development was driven by exports, which soared by 28.8% y/y, while imports increased moderately by 7.7%. However, the trend of an improving trade balance was reversed in recent months when the trade gap widened again for the first time since December 2008. Agriculture and manufacturing were the main sectors recording export growth. As a result, the current account deficit fell by 37.3% year-on-year in the first half of 2010. Bosnia and Herzegovina's external public debt increased by 22.6% in 2009, mainly due to the disbursements made in the context of the IMF programme and the activation of an optional debt to the London Club in December 2009. In terms of GDP it increased from 17.2% to 21.8%. In the first half of 2010, public foreign debt rose by another 13%. Public international creditors account for 88% of the country's foreign debt. The largest creditor remains the World Bank group. Official foreign exchange reserves have remained relatively stable since the last quarter 2009, covering around six months of imports. Overall, external imbalances have continued to adjust, characterised by a significant narrowing of the current account deficit towards a more sustainable level.

The unemployment rate in 2009 was very high at 24.1%. According to the Labour Force Survey conducted annually in May, unemployment significantly increased to 27.2% in 2010 from 24.1% in 2009. It was particularly high among the young population (48.7% for people between 15 and 24). Measured according to the national registry, the rate was 43.2% in July 2010. The sector most affected by rising unemployment in 2010 was the processing industry. On the other hand, the highest growth of employment was registered in financial intermediation and transport. Workers were laid off mainly in the private sector while the number of employees in the public administration increased by 1.6% year-on-year in 2010 (January-July). After the very high wage increases of previous years, nominal gross wages still rose by 3.4% in 2009, but then decreased by 0.5% in 2010 (until July). Structural rigidities such as the high rates of social contributions and low labour mobility continue to hamper job creation and labour market participation. High and poorly targeted social transfers reduce the propensity to work, further highlighting the need for reform of the social benefits system. Overall, labour market conditions remained fragmented and rigid.

Annual inflation was negative in 2009, reaching -0.4%, down from 7.4% in 2008. The disinflationary trend was mainly driven by falls in transport, energy and food prices. This downward pressure was,

however, reversed in early 2010. Annual inflation rose to 1.7% in August, bringing the 12-month moving average inflation rate up to a moderate 1%. Inflation in 2010 is driven by a hike in excise duties on tobacco and alcohol, as well as transport and communication costs following international price developments. The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the anchor currency. Monetary policy settings have remained unchanged since May 2009 after minimum reserve requirements had been lowered in several steps from October 2008 in order to boost the liquidity of the banking sector during the financial turmoil. The monetary aggregate M2 increased by 9.5% y/y in August. Overall, the currency board has continued to function well and monetary and financial stability have been preserved while inflation slowly picks up.

The fiscal situation of Bosnia and Herzegovina worsened significantly in 2009. The share of general government in GDP remains high, with 2009 revenues at 43.1% of GDP and expenditures (including net lending) at 47.6%, thus creating a budget deficit of 4.4% of GDP in 2009 (2.2% in 2008). Following the agreement on a Stand-by Arrangement with the IMF earlier in the year, the Federation revised its budget three times in 2009 and Republika Srpska twice. The 2010 budgets were dominated by a further need for fiscal consolidation, mainly through a reduction of current expenditures. Substantial savings were envisaged in the public sector wage bill and in transfers due to the elimination of special unemployment benefits for demobilised soldiers, the implementation of eligibility audits for civil and war benefit recipients and strict control over pensions provided on favourable terms. The state level froze wages in 2010. After initial delays, the Federation advanced the reform agenda over the summer: The parliament adopted a new civil service wage law at the end of July rationalising the wage bill by inter alia consolidating a large number of allowances into the base wage. The government approved a pension reform strategy which however was later withdrawn from parliamentary procedure. Eligibility audits of privileged pension and war disability benefit recipients started in July, albeit slowly. The Federation also rebalanced its budget in September 2010 in order to apply with IMF requirements and to account for increased revenues. In Republika Srpska wages in public administration were cut by 10% (and 15% for the highest paid employees). An eligibility audit for social transfers was conducted in Republika Srpska, reducing the number of beneficiaries.

In the first half of 2010, deficits remained below those targeted in the IMF programme, mainly due to improved revenue collection (increasing by 2.9% year-on-year). As regards indirect taxes, this increase resulted mainly from the growth of revenues from excise duties and road tolls, which had both been increased in the context of the IMF programme. Collection was nevertheless still lower than in the pre-crisis period (first half of 2008), especially VAT, where there has been no change of taxation policy. As regards direct taxes, the highest increase was registered in corporate profits tax. Expenses increased by 3.1% year-on-year in the first half of 2010. Current spending dominates the budgets with wages accounting for 29% of overall expenditure and social benefits for 38%, both marginally lower in relative terms than in 2009. While the wage cuts resulted in a decrease of the nominal wage bill by 2.2%, social benefits were still rising by 2%. An agreement on a permanent formula for the allocation of indirect tax revenues to the state, the entities and the Brčko District is still pending. The Fiscal Council failed to adopt the global fiscal framework for 2011-13 within the deadlines prescribed by law. Overall, budgets are still not self-sustaining and depend on international support, especially in the Federation, even though the state of public finances is improving. The pace of implementation of fiscal adjustment and structural reform measures agreed in the context of the intervention by the international community is uneven.

General government debt, both domestic and foreign, stood at approximately 35% of GDP in 2009, up from 28% in 2008. The total amount of domestic public debt is still subject to verifications related to old foreign currency savings and wartime claims. Nevertheless, it was estimated at around 13% of GDP in 2009 (up from 11% in 2008). Domestic public debt is managed and served by the entities (50.7% Federation, 47.1% Republika Srpska, 2.2% Brčko District). Both Republika Srpska and the

Federation continued issuing bonds in 2009 and 2010 to service the debt. The government of the Federation amended the debt law allowing local authorities to issue municipal bonds as already practised in Republika Srpska. Overall, even though the debt-to-GDP ratio is still relatively moderate, its recent growing trend needs to be monitored carefully.

The sharp economic downturn of 2009 revealed the vulnerabilities of the country's growth model relying on externally financed consumption, thus creating large external imbalances. The productive capacity and the competitiveness of the economy remain weak as domestic sources of growth are not adequately exploited and national saving is too low. The currency board arrangement enjoys a high level of confidence and credibility, while fiscal policy decisions remain erratic, in particular in the Federation, which undermines their reliability and predictability, despite adjustments and reforms pursued under the international support programmes. Overall, the viability of macroeconomic policies suffered from the structural weaknesses of public finances, even though external imbalances have improved and financial and monetary stability has been preserved.

#### **Interplay of market forces**

The private sector's share in GDP is estimated to have remained stable at around 60% of GDP in 2009. In Republika Srpska around 69% of the initial stock of state-owned capital intended for privatisation had been sold by May 2010, practically unchanged from a year earlier. After a series of failed privatisation deals the privatisation agency of the Federation developed a revised action plan for 2009-10, including the privatisation of the entire public share in eight companies. However, the main public enterprises in the Federation, including the two telecom operators, are not covered. Progress on the plan is very slow and several auctions have failed as they did not attract interested parties. The privatisation of an 88% share in the aluminium company Aluminij d.d. Mostar, one of the largest enterprises in the country and a key source of export revenue, which had been pending for more than three years, was declared to have failed. The value of the state's capital in public enterprises in the Federation has fallen in recent years, as many were inefficiently managed, recorded losses and are indebted towards the entity's budget, which also limits the scope for successfully privatising them. Most prices are liberalised even though a number of administered prices remains. Overall, the privatisation process did not advance for a second consecutive year.

#### **Market entry and exit**

During 2009 the court registration process for companies registering for the first time was shortened from 5-45 days to 5-20 days; an electronic application form for company registration was made available on the web pages of some courts. However, companies must still register in both entities if they want to do business in the whole country, and procedures remain different. The law on foreign investment policy was amended in order to shorten the lengthy procedure for starting a foreign-owned business (on average 83 days in 2009). The requirement to register foreign direct investment with the State Ministry of Foreign Trade and Economic Relations has been removed; only registration with local courts is now required. Republika Srpska established five specialised commercial courts responsible for resolving commercial lawsuits, bankruptcy and insolvency procedures, and registration of companies. The transfer of numerous cases from the municipal courts to these newly established commercial courts is expected to speed up and harmonise business-related legal proceedings. Republika Srpska reduced the time for the completion of bankruptcy proceedings to one year for companies with assets of less than €2.5 million, and to two years for larger companies. The respective legislative amendments also increased the threshold for the appointment of a bankruptcy administrator to €2.5 million, compared to €0.5 million before. The 'legislative guillotine' project to reduce administrative burdens has been completed in Republika Srpska. In the Federation, the parliament amended 34 laws in July 2010 initiating the second stage of this regulatory reform, simplifying and streamlining 35 priority administrative procedures. Businesses nevertheless continue to suffer from political instability, the high tax burden, and slow contract enforcement and business registration

procedures. Overall, some improvements in the business environment can be recorded, particularly in Republika Srpska, but reforms are not sufficient to substantially foster private sector developments.

### The legal system

No material improvements can be recorded as regards the complex and challenging legal environment in Bosnia and Herzegovina. While in some areas the standard of legislation is relatively high, the practical implementation and application of laws is often poor due to the weak enforcement capacity of key institutions. A law on commercial arbitration does not exist. The rule of law is weak, notably the judicial system often does not function efficiently, is subject to obstruction by the parties and does not cover commercial activities adequately. Property registers are largely unreliable. Overall, weak rule of law, prevalent corruption and unreliable contract enforcement continue to hamper the business environment.

### Financial sector development

The financial sector in Bosnia and Herzegovina is dominated by banks that mainly engage in traditional credit and savings activities. The share of claims to the private sector in relation to GDP stood at around 58% in mid-2010, up from 54% a year earlier. 30 banks operate in the country, of which 21 are in foreign ownership, seven in domestic private ownership and two majority state-owned, unchanged from a year earlier. The concentration of the banking sector remained at nearly the same level as in 2008; the five largest banks controlled almost 60% of total assets of the banking sector. Banks with foreign ownership accounted for more than 90% of the total banking system assets in 2009, even though they reduced their exposure towards Bosnia and Herzegovina by 9%, experiencing some difficulties in maintaining their commitments under the European Banking Coordination Initiative due to the lack of credit demand and of available instruments to invest excess liquidity (e.g. lack of government treasury bills and bonds). Banking sector assets increased somewhat in 2010, by 2.6% (August compared to December 2009). The capital adequacy ratio fell from 16.1% at the end of 2009 to 15.1% in the second quarter 2010, still comfortably above the legal minimum of 12%, which itself is significantly higher than the 8% required in the Basel II accord.

The aggregated net profit of the banking sector declined by 70% in 2009. Nine banks recorded losses. Following the economic downturn with a lag, the quality of the loan portfolio is deteriorating: The share of non-performing loans to total loans more than doubled from 4% in mid-2009 to 8.7% in the second quarter 2010, the highest level since 2004. However, this is not only due to an increasing volume of non-performing loans, but also to the decreasing volume of total loans. Banking profitability indicators have also worsened: The return on average equity turned negative in the second quarter 2010, decreasing from 1.3% in mid-2009 to -2.9%, its lowest level since 2002. The return on average assets fell from 0.1% to -0.3%. Liquidity indicators remained relatively stable with the rate of liquid to total assets rising from 28.5% at mid-2009 to 29.5% in the second quarter 2010, and liquid assets to short-term financial liabilities marginally falling from 49.5% to 49.3%. The situation was worse in the micro-finance sector, where the proportion of poor quality loans had risen to 20% as it was – contrary to its traditional role – heavily engaged in consumer lending. To improve the oversight of this sector, it has been brought under the supervision of the Banking Agencies and the credit register. A Standing Committee for Financial Stability, comprising the Central Bank, the Banking Agencies and the Ministries of Finance, was established in the context of the IMF programme and had its first meeting in May 2010. The limit on guaranteed bank deposits was further increased to around €18,000 (from around €10,000) as of April 2010. Overall, despite an interruption of banking sector growth, lower profitability and a deterioration in asset quality, financial stability was safeguarded.

Annual credit growth turned slightly positive again reaching 0.6% in August after it had been negative since September 2009, confirming the upward trend of recent months. Loans to households continued to drop (by 3%), though at a decreasing pace, but those to private enterprises were growing by 2.2%.

Deposits recovered in an annual comparison, growing by 6.5% in August, a clear sign of the return of confidence in the banking sector. This development is mainly due to private households, which increased their savings by 14.1%, while the corporate sector increased its deposits by 8.6%. As a consequence of these developments, the loans-to-deposit ratio declined from 118.7% in September 2009 to 111.4% in August 2010. The spread between average loan and deposit interest rates of commercial banks increased by 26 basis points in the first quarter 2010 to a level of 7.96 percentage points, due to lower deposit rates. This level points to still high intermediation costs. Overall, the difficult economic environment has caused market agents to become more risk-averse.

Local stock markets continued to decline. The main index of the Sarajevo Stock Exchange lost 15% in the first three quarters of 2010; that of the Banja Luka Stock Exchange fell by 13.5%. The cumulated turnover at Sarajevo fell by 47% in the first three quarters of 2010 compared to the same period in 2009; at Banja Luka the drop was far less pronounced at 1.3%, but this figure is blurred by one major emission in July. The combined market capitalisation declined to around 44% of GDP from rates at around 50% in 2009 and 100% in 2008. The insurance sector remained small and relatively weak. Its growth lost pace in 2009 when it decelerated to 1.35% (annual growth of premiums). The market was dominated by the non-life insurance segment, which accounted for 85% of the total. 26 companies were active on the market in 2009, two more than in the previous year. Overall, financial intermediation by the non-banking sector remained shallow.

## **6.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

### **Existence of a functioning market economy**

While external imbalances have been decreasing, fiscal imbalances are still high despite short-term adjustment measures undertaken in the context of the international support programmes. The reform of the system of social benefits contributes to fiscal consolidation and better targeting of benefits to those really in need. However, its sluggish implementation, the still slow pace of economic restructuring, especially in the Federation, prevailing obstacles to private sector development and the excessive influence of the public sector in the economy continue to undermine a more growth-oriented allocation of resources and a strengthening of domestic sources of growth. Progress towards creating one single economic space within the country, a key European Partnership priority, has been limited. Coordination on economic and fiscal policies has been insufficient. Overall, the functioning of market mechanisms remained hampered by distortions, an excessive role of the state and lack of competition.

### **Human and physical capital**

Information on the endowment of human capital remains scarce. The law on vocational education has been adopted, but not yet implemented. So far, cooperation between vocational education schools and employers is only pro forma and the profile and number of graduates coming out of the vocational and educational training system often does not correspond to the employers' needs. A curriculum for a nine-year education in all primary and secondary schools country-wide was implemented as of the school year 2009/10. Overall, structural rigidities and the weak performance of the education system, in particular delays in reforms of vocational education, continue to contribute to the skills mismatch, hampering the proper functioning of the labour market.

The ratio of investment to GDP dropped significantly from 24.4% in 2008 to 19.1% in 2009. Investment in road and rail infrastructure continued, in particular on corridor Vc. The 'Railway Package II' directives on rail safety have been partly implemented through the issuance of safety instructions by the Bosnia and Herzegovina Railways Regulatory Board. The railway companies of the Federation and Republika Srpska joined those of Slovenia, Croatia and Serbia establishing a

regional railway alliance. The reform in accordance with the Addendum to the Memorandum of Understanding on the development of the South-East Europe Core Regional Transport network for a South-East European railway transport area has not been completed. Net foreign direct investment (FDI) flows dropped by more than 70% in 2009, falling to 1.4% of GDP. There were considerable outflows of FDI in the financial sector. Manufacturing and trade accounted for more than 80% of FDI inflows. In the first half 2010 net FDI actually turned negative. Overall, the upgrading of physical infrastructure continued, though at a slow pace.

### **Sector and enterprise structure**

The planned restructuring and liquidation of socially-owned enterprises has made only slow progress. The entry of foreign investors has completed the privatisation and liberalisation of the oil derivatives market.

Electricity and gas utilities continue to be public stock companies. Their unbundling and restructuring has not been completed yet. In the Federation, the country's biggest power utility company merged with seven coal mines in 2009. It now needs to inject capital into the mines for their modernisation and restructuring. Market liberalisation remains insufficient as most utility providers still do not apply market prices. Although the market was opened for non-household consumers, they have little incentive to change suppliers as regulated tariffs remain below market prices.

As for unbundling of the electricity networks, progress has been uneven across entities. Republika Srpska completed unbundling of generation from distribution and supply in 2008, but has not yet unbundled the latter two activities. In the Federation no unbundling has occurred so far.

Progress towards a competitive telecommunications market has been limited. The incumbent operators continue to act as de facto monopolies in their respective fixed-line market segments and as oligopolists in the mobile segment. As a result, new entrants have not gained traction. Overall, little progress was achieved in the liberalisation of network industries.

As a consequence of the economic crisis a small shift in the sectoral structure of the economy towards services could be discerned in 2009, in particular at the expense of industrial production. Services accounted for 65% of gross value added (up from 63.7% in 2008), industry and construction for 26.2% (27.5%) and agriculture for 8.9% (8.8%). The contribution of public administration, education and health, already at a high level, further increased to 22%. The informal sector, fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime, remains large. It reduces the tax base and the efficiency of economic policies. Overall, there have been no major changes in the structure of the economy. The informal sector is an important challenge.

### **State influence on competitiveness**

The large public sector absorbs significant parts of the labour force and continues to act as a wage setter. However, while in previous years high wage increases hampered the competitiveness of the Bosnian economy, the recent reductions in public sector wages can have a reverse effect. In 2009, direct budget subsidies to industry and agriculture increased to a consolidated 1.7% of GDP from 1.5% in 2008. In the first half of 2010, they increased by 16.8% annually. Indirect subsidies continue to be sizeable. Bosnia and Herzegovina has still not established a state aid authority as required by Article 36 of the Interim Agreement. Overall, state influence on competitiveness remains high.

### **Economic integration with the EU**

Bosnia and Herzegovina remains an open economy even though total trade (added volume of exports and imports) declined significantly in 2009, falling from around 94% of GDP in 2008 to approximately 76%, mainly due to the steep drop in imports. In 2009, the real effective exchange rate based on the country's 20 largest trading partners depreciated marginally. The EU continues to be the largest trading partner, with shares of 54.5% of total exports and 45.9% of total imports in the first eight months of 2010 (goods only). While the share of exports to the EU has increased slightly, the share of imports has decreased slightly. The other main trading partners remain the countries of the CEFTA region, accounting for 33.9% of exports and 26.9% of imports. The share of net FDI inflows from the EU to total net FDI inflows decreased to 24% in 2009 from 55% in 2008, mainly due to net FDI outflows in the financial sector caused by constraints in the home markets of some parent banks. Overall, the level of integration of trade with the EU remained fairly high.

### **6.3. Conclusions**

The economy of Bosnia and Herzegovina made a moderate recovery in 2010 being in recession in 2009. The recovery is mainly driven by external demand. Unemployment remained at very high levels. The fiscal situation worsened significantly in 2009 as public finances came under severe stress due to both declining revenues and high spending commitments. The commitment to structural reforms and sound public finances remained uneven across the country. Some fiscal and structural reform measures have been enacted recently under the pressure of budgetary imbalances and the IMF programme. Nevertheless, budgets are still not self-sustaining and the quality of public finances remains weak.

As regards the economic criteria, Bosnia and Herzegovina has made little further progress towards a functioning market economy. Considerable further reform efforts need to be pursued with determination to enable the country to cope over the long term with competitive pressure and market forces within the Union.

Implementation of the Stand-By Arrangement with the International Monetary Fund has been broadly satisfactory. Financial and monetary stability was preserved. The currency board arrangement continued to enjoy a high degree of credibility. Confidence in local banks has returned and households redirected their savings to the banking sector throughout 2010. Industrial production slightly increased in the first half of 2010. Mainly influenced by international price developments, inflation returned to positive yet low rates in early 2010. Due to soaring exports, external imbalances have decreased. Some limited improvements in the business environment can be reported, in particular regarding business registration.

However, the fiscal situation in Bosnia and Herzegovina remained difficult, especially in the Federation. Commitment to the agreed fiscal adjustment and structural reform measures, as well as their implementation, was uneven across the country. The quality of public finances remained low with high shares of current expenditures to GDP. Privatisation, restructuring of public enterprises and the liberalisation of network industries did not advance. Upgrading of infrastructure has proceeded, though at slow pace. The productive capacity and the competitiveness of the economy remained weak as domestic sources of growth were not adequately exploited. Structural rigidities such as the high rates of social contributions and low labour mobility continue to hamper job creation and labour market participation. The high and poorly targeted social transfers reduce the propensity to work, further highlighting the need for reform of the social benefits system. Unemployment continued to be very high and the informal sector remains an important challenge. The business environment is affected by administrative inefficiencies and the weak rule of law.



## 7. MONTENEGRO

In 1993, the European Council in Copenhagen defined the following economic criteria for accession to the EU:

- the existence of a functioning market economy;
- the capacity to cope with competitive pressure and market forces within the Union;

These criteria are linked. A functioning market economy will better cope with competitive pressure and, in the context of membership of the Union, the market of reference is the internal market.

Following a brief overview of economic developments and policies in a historical perspective, the report goes on to consider the extent to which Montenegro fulfils the two economic criteria established by the Copenhagen European Council.

### 7.1. ECONOMIC DEVELOPMENTS

Montenegro is a very small economy, with a population of approximately 630,000 distributed over a mountainous territory of 13,812 square kilometres. The country has natural resources, mainly bauxite, coal and wood, but also significant hydrological potential, and a favourable climate for agriculture and tourism. The country has witnessed a profound transformation of its economic structure in the last decades, from a socialist republic of the former Yugoslavia, dependent on a few heavy industries to an open service based economy. Gross domestic product reached €3 billion in 2009, or 0.02% of EU-27's GDP. In purchasing power parity terms (PPP), GDP per capita amounted to €10,200 in 2009, or 43% of EU-27 average, up from 29% in 2000. Income disparities are significant between the more populated and richer south and the less developed north of the country.

#### Macroeconomic background

Montenegro, with a GDP per capita of roughly 75% of the national average, was one of the poorest republics of the former Socialist Federal Republic of Yugoslavia, and highly dependent on the traditional guaranteed Yugoslav market. In the 1990s, the country was hit by the loss of the internal Yugoslav market, and by several years of international embargo, which severely depressed the industrial sector. This resulted in a dramatic contraction of economic activity, hyperinflation and a banking system unable to perform its intermediation functions. The Deutsche-Mark became a de facto parallel currency. Illegal practices such as cigarettes and petrol smuggling, bypassing official channels for financial transaction, under-invoicing of exports, informal employment and the grey economy were tolerated and flourished.

In the Federal Republic of Yugoslavia (FRY), established together with Serbia in 1992, Montenegro acquired responsibility for its own monetary policy and customs, but shared with Serbia the federal budget and the currency. The recovery of the economy began only after 2000, when Montenegro started decoupling from Serbia politically and economically, notably in terms of public finance and currency. In 2000 the fiscal deficit was stabilised at over 8% of GDP and fully financed by an emergency post-conflict assistance from the IMF and the EU. It was further reduced in subsequent years, and turned into a significant surplus in 2006 and 2007. Prospects for external sustainability were also enhanced by the Paris Club decision in 2001 to redeem 66% of the FRY's debt. Until 2000, public sector accounts lacked transparency, with a proliferation of extra budgetary accounts with earmarked revenue, and accounting practices at odds with international standards. To remedy this, a set of tax laws was adopted to modernise the administration and the introduction of the VAT shifted the tax burden towards indirect taxation. Social contributions and the personal income tax rates were reduced. All fiscal revenues from customs and indirect taxes, as well as from privatisation were

channelled to the state treasury, therefore improving tax collection management and enhancing fiscal transparency.

Since its establishment in 2000 the Central Bank of Montenegro (CBCG) engaged in the reform of the banking sector to reinforce the soundness of the banking system and adopted prudential regulations and supervision in line with international standards. In 2001 the Deutsche-Mark became the only legal tender in Montenegro, unilaterally replaced one year later by the euro (see Chapter 17, Economic and monetary policy). The constitution establishing the State Union of Serbia and Montenegro in February 2003 confirmed the existence of different monetary, exchange, customs and tax regimes for both republics.

Severe unemployment was a key problem during the conflict years in the 1990s when wages fell drastically and social programmes collapsed. Over time, labour market indicators improved, benefitting from both labour market reforms and stronger economic growth. The recorded unemployment rate which stood at 32.7% in 2000 decreased to 10.7% in 2008 before reaching 11.9% in mid-2010, as a result of the crisis. However, the activity rate has remained close to 50% over time.

After it had contracted in the 1990s, the economy gradually recovered after 2000, to peak in the period 2006-2008 when it grew on average 8.7% annually. The regained confidence in the banking system, high foreign direct investment inflows, increasing tourism and some key privatisations boosted this growth. However, the rapid expansion of the financial sector rendered Montenegro very vulnerable to the global financial crisis which started in October 2008. The most affected sectors were the metal industry, construction and financial intermediation. As a result, in 2009 GDP declined by 5.7%. The economy showed some signs of recovery in mid 2010, as the banking sector gradually stabilised, and the tourism industry remained resilient during the crisis.

### Structural change

Montenegro underwent rapid industrialisation in the 1970s, establishing an aluminium complex and the accompanying large infrastructure (railways, port and electric power plants). In the 1980s, the aluminium industry and related activities accounted for 50% of GDP and exports. After the 1990s, in parallel with the country's transition to a market economy, Montenegro underwent a significant reorientation towards a more service based economy. In the period 2000-2009, the share of industry in gross value added (GVA) declined by 29%, and currently represents some 13.6% of GVA, while construction, services and agriculture accounts for 6.5%, 70% and 10% of GVA respectively.

Price liberalisation, which started in the late 1980s, was largely achieved by 2001. The privatisation of socially-owned assets, launched in 1989, resumed 12 years later, when the government engaged in privatisation through a dual approach: on the one hand, a mass privatisation accomplished via vouchers distribution to citizens; on the other hand, the sale through international tenders of majority shares in 15 large companies. By 2006 some 86% of total state capital had been privatised. Since then, the government has been slowly selling off the remaining state ownership.

A series of reforms were introduced to strengthen confidence and turn financial intermediation into an important contributor to economic growth. Driven by the completion of the privatisation process, the banking sector expanded very rapidly, and it is currently dominated by foreign capital (81%). Although it remains the most developed component of the financial sector, its structure is highly concentrated and capitalisation is low.

The contribution of domestic capital to growth has always been limited. Following the improvements of the business environment and liberalisation FDI became a major source of investment, averaging very strong levels of over 20% of GDP since 2005. Both road and rail transport infrastructure as well as electric transmission grid have been historically inadequate. Montenegro has started building power

stations but the installed capacity is insufficient at present. In the past few years several educational and vocational training reforms were introduced with a view to align the supply side with market requirements. However the skills mismatch remains significant and in a number of low qualified labour intensive sectors the country continues to resort to foreign workers.

Table 7.1:

**Montenegro - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	4.2	8.6	10.7	6.9	-5.7	N.A.
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	-7.7	:
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	-25.3	:
Unemployment	%	18.5	14.7	11.9	10.7	11.4	12.2
Employment	Ann. % ch	0.6	4.5	3.7	6.3	4.8	1.1*
Wages	Ann. % ch	8.0	15.6	14.2	22.8	5.7	8.2
Current account balance	% of GDP	-8.5	-24.7	-37.8	-50.7	-30.1	-29.1
Direct investment (FDI, net)	% of GDP	21.0	21.7	19.9	17.9	30.6	31.0
CPI	Ann. % ch	2.4	3.0	4.3	7.4	3.4	0.5
Interest rate (3 months)	% p.a.	1.20	1.21	:	:	:	:
Stock markets	Index	5,670	14,406	36,159	19,947	13,303	14,235
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-2.3	2.7	6.4	-0.4	-3.6	-0.8
General government debt	% of GDP	38.6	32.6	26.3	29.0	38.2	35.8

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

## 7.2. ASSESSMENT IN TERMS OF THE COPENHAGEN CRITERIA

### 7.2.1. The existence of a functioning market economy

The existence of a functioning market economy requires that prices, as well as trade, are liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and consensus about economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of any significant barriers to market entry and exit improve the efficiency of the economy.

#### Economic policy essentials

Montenegro has achieved a broad domestic consensus in the country on the fundamentals of economic policy required by EU membership as well as a track record in the implementation of economic reforms. Since the early 2000s, the coalition government has remained cohesive and strongly focused on economic reforms and EU accession. The country has implemented substantial reforms which continued over time with no policy reversal. Montenegro takes an active part in the Commission fiscal surveillance and reporting arrangements applying to potential candidate countries since 2006. Overall, the authorities maintain reform momentum by efforts to establish a business friendly environment, in particular for attracting foreign investment.

#### Macroeconomic stability

Since independence, the economy has experienced very strong growth, averaging 8.7% between 2006 and 2008, boosted by strong inflows of FDI and very high credit growth which financed a robust increase in domestic demand. Services, notably tourism, financial intermediation and real estate, remained the main drivers of growth. Moreover, the annual share of investments (GFCF) remained high at 30.8% of GDP on average during these three years. On the demand side, the strong performance of private consumption, with retail sales expanding by 35% in real terms from 2006 to 2008, was supported by increasing household incomes due to rising real wages and bank credit,

expanding annually on average by 21% and 105% respectively. However, in 2009 the global crisis affected severely the economy, revealing vulnerabilities in the growth pattern. GDP declined by 5.7% driven by a sharp contraction in manufacturing and mining but also in investment and private consumption. Only net-exports and public consumption contributed positively to real GDP growth. In the first quarter of 2010, the economy continued to contract in real terms by an estimated 1.5%. After 18 consecutive months of decline, industrial production indices turned positive (8.7% year-on-year) in April 2010, mainly due to positive growth in the metal industry, which benefitted from the rise of commodity prices and the implementation of the restructuring programmes. The recovery of the industrial sector remains nevertheless fragile while demand is constrained by tight credit conditions. Overall, until 2008 the economy has witnessed several years of strong growth driven by domestic demand and foreign investment. However, the financial crisis had a significant impact on economic growth.

On the external side, the current account deficit raised mainly due to the merchandise trade gap. Exports have been highly concentrated on a few sectors, in particular metals and tourism. The level of merchandise exports has historically been very low, with a peak of some 30% of GDP in 2006, which decreased progressively towards 10% of GDP in 2009. In general, the level of value added and diversification of exports is low, with aluminium accounting for 50% of total exports of goods and steel for an additional 15%. However, the volume of service exports, in particular tourism, has been growing continuously, reaching some 23% of GDP in 2009. Unlike exports, imports surged (40% annual growth) since independence, as a result of the very strong increase in domestic demand. Subsequently the trade and the current account balances deteriorated strongly. The latter rose sharply, from a deficit of 8.5% of GDP in 2005 to a record high of 51% in 2008, to decline to 30% by the end of 2009 due to the adjustment brought by the crisis. In 2010, exports' growth improved while imports' contraction continued until June, resulting in a further improvement of the trade balance. The current account deficit reached 29% of GDP at the end of June 2010. The drop follows a reduction of 5% year-on-year of the trade deficit for goods which, however, still remains very high (45% of GDP). The balances of services and current transfers improved in the first half of 2010 by 8% and 40% year-on-year, while the income balance remained marginally positive. In the first six months of 2010 the current account deficit was practically financed by net FDI while Central Bank reserves increased by EUR 35 million. Overall, external imbalances and the dependence on external financing are still very high.

Net FDI inflows remained buoyant (22% of GDP annually on average) from 2006 until mid-2010. While they significantly contributed to the financing of the current account deficit, their concentration on the non-tradable sector, in particular real estate, the financial sector and tourism, also contributed to increase volatility in real estate prices. The crisis has led to a more sustainable allocation pattern in 2009, less dependent on investment into real estate, which accounted for 47% of total inflows in the period 2006-2008 and dropped to 16% in 2009. Meanwhile investments in domestic companies, notably for capitalisation of banks, privatisation of the electricity company, and for additional investments in telecommunications, increased from 36% in 2008 to 69% of 2009 total investments. Overall, while in recent years large FDI inflows and private lending financed the large external imbalances; the sustainability of these inflows is not ensured.

Like the overall economy, the labour market registered accelerated structural change in recent years. Employment in mining and heavy industry has been declining, reaching 14% in 2009, while employment in tourism and construction increased to 15% in 2009. Employment in the public sector represents some 25% of total employment, while employment in agriculture is rather low (6,5% of the labour force in 2009). Currently some 60% of the working age population actively participates in the labour market. Data on unemployment varies strongly, with registered unemployment rates between 10-15% of the labour force, while Labour Force Survey (LFS) data points to unemployment rates close to 20%. In the pre-crisis period employment increased benefiting from strong economic growth and the positive effects of labour market reforms. Employment expanded by 4.8% annually, with a

gradual shift from industry to services. The registered unemployment rate decreased from 14.7% in 2006 to 10.7% in 2008 but rose again to 11.4% end-2009. During the first three months of 2010 unemployment continued to rise to 12.4%, mainly due to the restructuring of the metal and mining sector. The employment rate of women increased from 27.6% in 2005 to 34.4% in 2009. However, according to the labour force surveys, their participation remained stable over time at some 40% of total labour force. In the same period, the unemployment rate of young people (15 to 24 years old) has dropped, from 58% in 2005 to 35.6% in 2009.

Informal employment, which according to estimates by the Employment Agency of Montenegro (EAM) had been around one third of total employment in 2003, declined during the years of strong growth, but appears to have increased again due to the crisis, to some 25% of the labour force in 2009. The persistence of this high level of informal employment suggests some structural rigidities. Furthermore, the reliance on temporary migrant workers for seasonal jobs in agriculture, construction and tourism and high vacancy rates for highly skilled jobs point to a significant mismatch between required and supplied skills. Overall, the labour market situation improved in recent years. However, the persistent structural unemployment and the high share of informal employment point to the existence of some structural rigidities.

Since 2002, Montenegro uses the euro as legal tender. This has contributed to anchor inflation expectations, but it prevents the use of a monetary and exchange rate policy as a macroeconomic policy tool to support the economy, especially in the context of an economic crisis. The use of euro led to low inflation rates (averaging 3.6% up to 2007). However, due to the size of the economy and its dependence on imports, inflation depends largely on international prices, particularly for energy and food. Therefore consumer prices increased sharply following the global surge in food and energy prices in 2008, reaching a peak of 11.4% in June. The economic crisis has had a pronounced disinflationary impact and the consumer price index dropped to 1.5% by the end of 2009, and recorded a modest cumulative increase of 0.5% in the first seven months of 2010.

Very rapid credit growth fuelled by low interest rates and strong competition for market shares in the banking sector led to a very rapid expansion of the money supply from 74% of GDP in 2006 to 112% in 2007. After increasing signs of overheating, the Central bank introduced restrictive measures in 2008 based on increased mandatory reserve requirements as well as the introduction of credit ceilings. These administrative limits to credit were removed by year end as the global financial crisis hit. Later in 2009, as the crisis unfolded the central bank was able to smoothen its impact by relaxing reserve requirements on banks. Overall, while risks to price stability appear to be low, there are constraints on the monetary policy due to the country's unilateral adoption of the Euro.

Since autumn 2008 the central bank has been very active trying to preserve the stability of the country's financial system. The government and the central bank adopted a set of measures to preserve the stability of the banking system, consisting in a full guarantee for bank deposits and the possibility of government credit support for eventual liquidity shortfalls of troubled banks. The relatively young banking sector which had undergone a very fast process of financial deepening has been a main channel of transmission of the global crisis. In October 2008, the significant fall of the Hungarian OTP Bank shares led to a bank run on its domestic subsidiary CKB, the largest bank with a deposits market share of 41%. Meanwhile, the second largest bank, Prva Banka CG, delayed payments to its depositors due to liquidity problems resulting from very poor asset quality and large exposure to the falling real estate market. By December 2009, bank deposits contracted further by 8.3% year-on-year and credits by 14.3%, while non-performing loans (NPL) surged from 4.6% end of 2008 to 10.3%. Banks reduced their exposure to credit risk to improve their balance sheets. After 16 months of continuous contraction, deposits growth turned positive in March 2010. However, banks credit activity took some additional time to recover, registering negative growth until July (-11.4% year-on-year). Overall, while banks are progressively re-establishing their deposits base, credit activity remains highly constrained.

Public sector revenues and expenditures accounted for some 45% of GDP on average during the last five years. During the economic boom and following reforms to broaden the fiscal base revenues had been increasing. However, public expenditures were also increased, in particular current ones on public administration wages and pensions which increased by 40% during 2006-2008, weakening the long-term sustainability of public finances. As a result, public spending jumped from 42.7% of GDP in 2006 to 50% of GDP in 2008. In 2009, the authorities tried to adjust to the sharp decline of revenues by consolidating spending: net wages of state administration were reduced by 7%, maintenance expenditures by two thirds, and expenditures of goods and services by almost 10%. Capital spending was also used as a buffer, through the reduction of planned works by more than half. These efforts resulted in a consolidated budget deficit of 3.5% of GDP in 2009, financed by foreign borrowing as well as receipts from privatisation. In the first half of 2010, the general government budget execution posted a deficit of 0.4% of GDP as a result of the restrictive fiscal policy that reduced expenditures by 6.3% year on year. Overall, fiscal policy has been pro-cyclical in recent years, exacerbating the overheating of the economy in the boom period and the economic downturn when the crisis hit the economy.

In the pre-crisis period public debt declined from 38.6% of GDP in 2005 down to 27.5% of GDP in 2007, notwithstanding previous debt redemption in 2001. The share of external debt remained stable at 70% of the total public debt. As from 2008 the public debt has been rising again, and reached almost 37% of GDP by the end of 2009. Domestic public debt increased faster than foreign public debt as the state assumed liabilities from restitution, pension arrears and restructured public companies. Simultaneously, foreign debt, mostly financed by international financial institutions, has been growing too, to cover infrastructure needs, the restructuring of troubled industries and the financing of the budget. The share of foreign debt represents currently around 60% of total public debt. Public debt fell slightly to 35.8% of GDP during the first half of 2010, rising to close to 40% in early September as the government placed successfully a €200 million Eurobond issue. Part of these funds will be used for the repayment of existing obligations as well as for increasing reserves. Overall, while still at a relatively moderate level, the public debt remains exposed to potential contingent liabilities including those deriving from state guaranteed loans.

The global financial crisis has challenged the foundations and sustainability of the recent years' growth model based on only a few cyclical sectors, rapid credit growth and high capital inflows to finance growth. The macroeconomic policy mix strongly relies on fiscal policy. It was used with some success until 2006 as a sizeable fiscal consolidation took place. However, public expenditures considerably increased in 2007-2008, exacerbating the economic overheating. As a result, when the crisis hit Montenegro in late 2008, margins of manoeuvre had been exhausted and the country had to engage in pro-cyclical budget cuts throughout 2009 and state guaranteed loans. Central bank interventions –even though limited to reserve requirements- contributed to curb down credit growth in the boom period and to dampen the effects of the crisis. The importance of structural reforms has increased with the crisis, leading to the reinforcement of the central bank's supervisory role and industry restructuring to increase competitiveness. Overall, given severe limitations on the monetary policy side and the limited fiscal space, the onus of economic adjustment lies to a large extent on structural reforms.

#### **Interplay of market forces**

Most price categories had been liberalized by the early 2000s. Since 2005, the Energy Regulatory Agency (ERA) sets electricity prices in relation to production cost thresholds. Only a small number of products are currently subject to administrative price control, including medicines and postal services, while local authorities may control the prices of certain utility services. The consumption of these regulated products (electricity, pharmaceutical products, water supply, sewerage and refuse collection) currently represents about 9% of total spending for an average household. Overall, the state influence on price dynamics is limited to some utility services.

By 2006, around 86% of originally state owned property had been privatised. The privatisation process is currently in its final stage. Key sectors like banking, insurance, and telecommunications have been fully privatised. A large majority (73%) of joint-stock companies are completely private. An additional 17% have more than half of private capital, and the remaining 10% have state ownership above 50%. Further progress has been recorded with the partial privatisation (44%) of the electricity company EPCG in 2009. The state still has majority shareholding notably in large networking industries: the local electric power company, the railways, ports, the shipyard, Montenegro Airlines, and the airports. Overall, the privatisation process is fairly advanced and state ownership has been reduced to some 14% of total assets.

### Market entry and exit

Since 2006, the process of business registration has been improved, reducing the number of procedures from 15 on average in 2006 to 12 in 2009, while the duration declined from 24 to currently 13 days. This might have facilitated the increase in new business registrations, which rose by 26% between 2006 and 2009. However, the time and cost to obtain a license for business operation remains the major constraint. Furthermore, differences in requirements and costs across municipalities create additional distortions. In 2008, the Council for the elimination of business barriers was established, becoming one year later the Council for regulatory reform and improvement of the business environment. One of the major outcomes was the adoption by the parliament in July 2010 of the Law on Improvement of the Business Environment, removing the requirement of annual renewal of companies in the business register, as well as cutting deadlines and fees for several administrative procedures. Overall, despite recent progress, business licensing procedures are still lengthy, delaying market entry of new companies.

The weak quality of domestic banks credit portfolio and, lately, the scarcity of foreign financing, have a significant impact on the risk premium and henceforth on persistently high interest rates close to two digits. The high cost of finance remains a major obstacle for setting up and developing companies. Overall, businesses are confronted with scarce and expensive financing.

At the time of the adoption of the Bankruptcy Law in 2002, bankruptcy procedures lasted more than one year. To improve the situation, a new law facilitating implementation and amending the Law on Company Insolvency was adopted in 2007. The new legislation helped to reduce the backlog of lawsuit and execution cases. Procedures have been reduced to six months on average, although for the most complex cases it may take up to one year. A total of 2,314 companies were liquidated in 2008 and 2,259 in 2009. Overall, market exit procedures have been streamlined and accelerated.

### Legal system

The lack of reliable land property ownership was a significant problem for investors in the past. Since 2007, new regulations have been introduced and implemented resulting in the average time required to register a property diminished to 21 days. Additional reforms in 2009 re-defined and clarified concession rights on public properties and resources. The Property Relations Law, and more recently, the entry into force of the Stabilisation and Association Agreement, provides the same treatment to EU citizens as to nationals for acquiring real estate. Overall, the registration of property is well advanced.

The two Commercial Courts are the main institutions for contract enforcement. The situation has gradually improved in recent years. In 2008 and 2009, the courts registered some 1000 new cases annually, with a backlog of some 800 cases from previous years. In the meantime the backlog is slowly being reduced. The average length of procedures has declined from 6 months in 2008 to 5 months in 2009. At present, 90% of cases are being resolved within three months. The regulatory framework also improved with the establishment of a mediation centre to facilitate simple resolution

of commercial disputes. The Agency for Amicable Labour Dispute Resolution, established in 2010, should enable workers to solve their collective or individual disputes without litigation. Efforts to fight corruption are dispersed as several institutions are engaged in this task at different levels. Furthermore, capacity for financial investigation is still insufficient; especially for using it as a means to fight corruption and organised crime (see Chapter 23: Judiciary and fundamental rights). Persisting weaknesses in law enforcement fuel the informal sector. Overall, recourse to the judicial system has increased progressively in recent years, as administrative capacity gradually improved. Weaknesses in the rule of law and prevalent corruption continue to negatively affect the business environment.

### Financial sector development

The small size of the market has not been an obstacle for the rapid development of a banking industry that became one of the main contributors to growth. Asset expansion has been very rapid. The ratio of banking sector assets to GDP rose from 56% in 2005 to 131% of GDP in 2007. Though the global financial crisis led to a significant decrease, they still represented 95.7% of GDP at the end of June 2010. The structure of assets is dominated by loans (78%), of which the corporate sector subscribed 55%, households 38%, the public sector 2.4%, and financial institutions the rest. Following the reform of the banking sector in 2005, credit soared by 105% on average from 2006 until 2008, but contracted by 14% in 2009 due to the impact of the global crisis. However, lending average real effective interest rates have remained steady at around 9.5% in the whole period (2006-June 2009). Operations with derivatives were introduced in 2009, although they remain marginal (€1.2 million in 2009).

The banking sector in Montenegro is dominated by foreign capital (81.3%), while domestic private capital accounts for 16% and state ownership 2.6%. The sector remains highly concentrated with four banks accounting for some 75% of assets, of loans and of total deposits. Montenegrin banks have historically been amongst the less capitalised ones in the region. Since 2003, when banks' capital amounted on average to 25% of total assets, the ratio deteriorated along with the surge of credit, reaching 8% in 2007, to slowly recover to 10.4% in mid-2010. Overall, the banking system has recorded a very rapid expansion driven by a low initial base and the entry of several major regional players. The sector remains highly concentrated.

The global crisis led to a sharp deterioration in the banking sector starting with a massive deposit withdrawal in late 2008. The authorities reacted quickly through measures aimed at bolstering confidence which, together with the liquidity provided by foreign parent banks, led to stabilisation during 2009. The government provided liquidity through a loan to the domestic ailing bank Prva Banka CG, while nine other banks did recourse to foreign parent banks support. Four banks out of eleven recorded a combined loss of €33.7 million by end 2009. Prudential indicators further deteriorated throughout the crisis. During the fast expansion of loans in the period 2006-2008, the loan portfolio of banks had already deteriorated rapidly and the share of non-performing loans (NPL) remained at 6.7% of total loans on average. By June 2009 the level of NPLs doubled, reaching 14.8%. Following, the deterioration of assets quality due to the high level of NPLs and consequent provisioning, banks return on assets (ROA) dropped from a level of 1% in 2006 down to negative values up to mid-2010 ( -3.5%), and return on equity (ROE) dropped more dramatically from levels above 6% in 2006 and 2007 to strong negative values until June 2010 (-34%). The results of the quarterly stress tests of the banking system performed by the CBCG during 2009 and 2010 confirmed the importance of credit and liquidity risks, especially for one large bank, and the need for capital injections. Overall, the economic downturn has revealed vulnerabilities and the need for adequate recapitalisation. Moreover, the full magnitude of the impact of the global crisis on the financial sector remains uncertain.

The parliament adopted in July 2010 a legislative package with a view to reinforce the stability of the financial sector and the intervention capacities of the central bank. Several laws were amended: the Central Bank Law; the Law on Banks, now introducing conditions for acquiring qualified



participation and for corporate management, and including the possibility for interim administration of a troubled bank; the Law on Bank Bankruptcy and Liquidation, defining the role of interim administration, the protection of the bankruptcy administrators, and including the possibility for the Central Bank to decide to sell the assets of a troubled bank. The new Deposit protection law establishes (progressively) banks deposit guarantees at €50,000 per depositor. Overall, the authorities have strengthened the legislative framework to address deficiencies in the financial sector, improving supervision and stability.

Stock exchange market capitalisation reached 272% of GDP in 2007, followed by a significant deterioration in 2008 to 110% of GDP. The stock exchanges showed some signs of improvement in the course of 2009, with market capitalisation rising to 162% of GDP to decrease again in 2010 to 142% of GDP at the end of July. The merger of the two stock exchange companies was approved in August 2010 with the consent of the securities commission. Despite its dynamic development, the role of the capital markets to finance domestic companies remains limited.

The insurance market has gradually expanded, though from a low base, accounting for only 3% of GDP by end-2008. Though there are 11 companies active in the sector in 2010, concentration is very high, with one company holding a 60% market share. The sector is dominated by car insurance, while the life segment, though developing fast from a very low base, accounts for some 12% of total premiums. The insurance law adopted in 2006 has established a supervisory agency independent from the Central Bank. The Law on Receivership and Liquidation of Insurance Companies in 2007 completed the legal framework, defining the terms and procedure of receivership, voluntary and judicial liquidation of insurance companies and the rights and liabilities of parties.

The adoption of the Law on Financial Leasing in 2005 enabled the fast development of this sector. However, in 2009 the market was severely hit by the crisis, and contracted strongly to 1.1% of GDP compared with 5.5% a year earlier. Overall, non-banking financial institutions play a limited role as a source of private sector financing.

#### 7.2.2. The capacity to cope with competitive pressure and market forces within the Union

The ability to fulfil this criterion depends on the existence of a market economy and a stable macroeconomic framework, allowing economic agents to take decisions in a climate of predictability. It also requires a sufficient amount of human and physical assets. Enterprises need to invest to improve their efficiency and innovate to adjust to a globalised and highly competitive external environment. Overall, the more an economy is integrated with the Union before accession, the better will it be able to take on the obligations of membership.

#### **Existence of a functioning market economy**

Montenegro is a small and very open economy with a private sector which currently accounts for some 84% of total shareholding. Prices, foreign exchange and trade regimes are liberalised. Given severe limitations on the monetary policy, the policy mix strongly relies on fiscal policy. However, due to an expansionary stance in the two previous years, margins for manoeuvre were severely constrained when the crisis hit Montenegro in October 2008. Furthermore, large external imbalances built up without being vigorously addressed, and combined with the credit and real estate boom exposed the country as the crisis unfolded. A number of important challenges still lie ahead, such as safeguarding financial sector stability and improving administrative capacities, crowding-in new private sector activities and increasing productivity, in order to improve the sustainability of economic growth, competitiveness and public finances. Overall, Montenegro has achieved a degree of macroeconomic stability allowing economic operators to make decisions in a climate of predictability. However, macroeconomic imbalances have exacerbated the country's exposure to the global economic and financial crisis. To become a functioning market economy Montenegro needs to address these

imbalances, as well as existing weaknesses, notably in the financial sector and the functioning of labour markets.

### **Human and physical capital**

As regards human capital, enrolment in education in both primary and secondary schools is relatively high, reaching 89% of the 5-14 years old group and 69% of the 15-19 years old respectively. It has increased over time. The number of university students has been rising even faster, reaching 3.6% of the total population. Overall, public spending on education has remained rather stable at 4.5% of GDP on average since 2006. Yet, improving quality assurance mechanisms and overall strategic approach to education that is connected to labour market needs remain the main challenges (see Chapter 26: Education and Culture). Regarding the development of a knowledge based economy, the latest available data indicates that gross domestic expenditures on R&D in Montenegro represented 0.1% of GDP in 2008.

Structural unemployment requires further reform of the education system notably vocational education (VET), and further training of the workforce in line with labour market needs. The proportion of published job vacancies unfilled is rather high (63% in 2009), which points to skill mismatches, but also a persistent lack of mobility, as most of the offers concern works in the coast and central areas. Current unemployment data point to weaknesses in vocational education. A 66% share of those registered as unemployed at the Employment Agency had vocational education, while their share represents only 20% in total employment. Several educational reforms are trying to align labour supply with market demand. A Law on National Vocational Qualifications with a new and wider system of qualifications was approved in 2008. Yet, the VET system continues to face serious problems in delivering high-quality education. The employment agency aims at smoothing the transition from education to work through cooperation with academic institutions, professional guidance, and programmes such as those for young managers having already graduated. Together with the Directorate for Small and Medium-sized Enterprises (SMEDA), it promotes self-employment and vocational training along with a strategy for life-long entrepreneurial learning. It is estimated, that these measures resulted in some 4,000 new employments since September 2009 until June 2010. Overall, qualifications and skills mismatch remain important issues.

With reference to physical capital, in view of the large savings and investments gap as measured by the current account deficit, the contribution of domestic capital accumulation to growth has been limited. Efforts have thus been focused on improving the investment environment so as to attract FDI which so far remained the major source of investment. The sectors benefiting the most from FDI have been telecommunications, real estate and tourism, followed by financial intermediation, and more recently energy. Gross fixed capital formation (GFCF) has been increasing steadily, reaching 38% of GDP in 2008 but decreased to 26.7% of GDP in 2009. During this period construction accounted for some 24% of capital formation. Hotels, retail trade, transport and communications were responsible for some 20% each of GFCF while manufacturing accounted for around 8%. Public capital spending declined to 3.4% of GDP in 2009 from 8.1% in 2008. Overall, while the level of investment has remained high, its contribution to the expansion of the production capacity has remained limited, as a significant share of foreign and domestic investment was directed to the non-tradable sector.

The electricity production and transmission system is underdeveloped and results in power cuts notably during the winter season. The average price of electricity, though 60% lower than in the EU, remains higher than in most neighbouring countries. To address these shortcomings, but also with a view to becoming in the medium-term a net exporter of energy, several projects have been launched recently to build new diversified capacities (hydropower, thermal, windmills) although they will take a few years before completion. Meanwhile the electric company is engaged in a series of activities to reduce transmission losses and to improve distribution efficiency. Overall, physical infrastructure

remains insufficient to cover domestic energy needs and the country relies on energy imports to satisfy domestic needs.

Transport infrastructure has been historically inadequate and hinders the efficient transport of goods and passengers. The railway company is investing to upgrade the infrastructure after several years of neglect. Overall, the transport infrastructure suffers from years of insufficient investment and a difficult topography.

All fixed telephone lines are digitalised. There were three mobile phone operators with a total market penetration just above 200% in 2009 and a fourth mobile operator license has been attributed in early 2010. However, the country only has 25,800 broadband internet subscribers (or 4% of total population) and internet use by companies is not yet widespread. Overall, telecommunications are already fairly developed, but some segments of the market such as broadband are at an early stage of development.

### **Sector and enterprise structure**

The contribution of the different sectors to output has evolved over the last decade. Agriculture represented 12.5% of total gross value added (GVA) in 2000, and despite a sharp reduction of employment over time, still retained 10% in 2009 which points to increased productivity of this sector. Major declines during this period were recorded in activities closely related with metallurgy: mining (from 2.9% down to 0.8% of GVA) and manufacturing (from 10.2% down to 5.9% of GVA). Construction, by contrast, increased its share in GVA from 4.3% in 2000 up to 6.5% in 2009. The share of wholesale and retail has remained stable, but it is still the highest in the economy (14.7% of GVA on average during 2000-2009). Transport accounted for 11.5% of GVA in 2009; financial intermediation for 4.2% on average between 2000 and 2009 and hotels and restaurants increased their share in GVA from 2.8% in 2000 up to 6.2% by 2009. The informal sector, fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime, remains large. It reduces the tax base and the efficiency of economic policies. Overall, the economic structure shifted markedly towards services over the last decade. The informal sector is an important challenge.

The industrial sector has been historically dominated by the metal industry, with aluminium and steel production together with their associated industries and services (mining, railways, harbour, and energy) accounting for 48.6% of GDP in 2002. Eight years later, the contribution of metals to the national economy has decreased significantly. Before the crisis, aluminium gross output represented less than 15% of GDP and steel 2.7% though their shares in total exports remain significant (39% and 11%). The drop in international metal prices has further endangered the viability of the aluminium and steel industries. The Niksic steelworks (ZNK) managed a reconversion with state support, mostly in form of bank guarantees and energy subsidies. However, the more distressed aluminium smelter (KAP) went through a partial re-nationalisation, with the state taking back 30% of the company's shares in exchange of a rescue package, including loan guarantees and an ambitious restructuring plan to halve production costs. Other economic sectors, notably tourism have developed more dynamically, contributing from less than 10% of GDP in 2000 to 16% of GDP in 2009. Overall, the relevance of Montenegro's heavy metal industry for the economy is declining as it suffers from deterioration in competitiveness, requiring large scale restructuring.

In the energy sector the restructuring of the power company (EPCG) was launched in 2008. After the separation of the transmission unit from EPCG in 2009, tariffs for the use of the network were established and secondary legislation adopted in the context of the SEE Energy Treaty, formally meeting all necessary preconditions for the development of a competitive electricity market.

In the transport sector, while restructuring is quite advanced, privatisation results are mixed. The railway transportation company separated its passenger unit from the freight unit Montecargo and offered for sale the latter in 2010 to an international railways cargo operator. The tender for the sale of the port of Bar container and general cargo operator failed. In both cases, the railways and the port, the government keeps the ownership of the infrastructure. So far, the national air carrier, Montenegro Airlines, has implemented the first stage of its foreseen restructuring by being transformed into a shareholder company. Overall, a large restructuring of strategic enterprises and sectors is underway.

The share of small and medium-sized enterprises (SMEs) in the economy has constantly increased over the recent years. However, SMEs remain largely focused on the domestic market and only around 15% of them export outside the former Yugoslav territory. Having benefited from the buoyant credit activity of banks until 2008, they are now faced with diminishing demand, increasing payment arrears, and stricter bank loans conditions due to the crisis. In 2009, the SME sector represented some 60% of GDP and employed 67% of the total workforce. SMEs face a number of persistent obstacles, such as delays and costs for obtaining municipal permits or the absence of spatial planning documents in some municipalities. Overall, SMEs have increased their weight in the economy but there is still ample scope for development.

#### **State influence on competitiveness**

The weight of subsidies in the consolidated budget has been historically low, accounting for less than 1% of GDP on average since 2003, very often related to privatisation clauses in view of restructuring the metal industries. During the crisis in 2009 and 2010, support to distressed companies mostly took the form of state guarantees (4.7% of GDP on foreign sources of financing and additional 1.8% of GDP to domestic ones), raising subsequent contingent liabilities for the public finances that may materialise later on. Electricity price cross-subsidisation amongst different class of users is being reduced and replaced with direct budget subsidies with the intention to avoid market distortions amongst consumers. An Administration for Protection of Competition and a State Aid Commission were established in 2008 (see Chapter 8: Competition). Overall, direct state aid has been limited but large state support interventions recently took place in the form of state guarantees for bank loans to distressed companies.

#### **Economic integration and convergence with the EU**

Montenegro remains a very open economy, with total trade (defined as the sum of imports and exports of commodities) close to 100% of GDP until 2008. However, 2009 witnessed a significant decline of trade, reducing the ratio of openness to 64% of GDP, as the most important trading partners (the EU and CEFTA), were also affected by the financial crisis. Exports to the EU contracted from 65% of total exports in 2008 to 48% in 2009, while exports to CEFTA increased from 33% in 2008 to 46% in 2009. However, the share of imports from the EU (40% of total imports in 2009) remained unchanged compared with 2008, while imports from CEFTA countries declined to 45% in 2009 from 50% a year earlier. During the first six months of 2010, exports to neighbouring markets witnessed a noticeable recovery, while exports to the EU as well as imports from CEFTA and EU markets still remained negative. However, the level of EU investment has remained high, reaching in 2009 almost 80% of total FDI. Relatively high inflation and wage growth after 2007 led to an appreciation of the real effective exchange rate (by 1.5% in 2008 and 5% in 2009), which, together with lack of adequate infrastructures, hampers Montenegro's international competitiveness. Overall, in recent years Montenegro suffered from deterioration in international competitiveness. Yet, the level of investment integration with the EU remains high.

### 7.3. CONCLUSIONS

As regards the economic criteria, Montenegro has achieved a certain degree of macroeconomic stability. However, to become a functioning market economy, as set out by the 1993 Copenhagen European Council, Montenegro needs to address internal and external imbalances, as well as existing weaknesses, notably in the financial sector and the functioning of labour markets, and strengthen the rule of law. In order to enable it to cope in the medium term with competitive pressure and market forces within the Union, Montenegro needs to strengthen its physical infrastructure and human capital and to continue implementing structural reforms.

Montenegro achieved a broad domestic consensus on the fundamentals of economic policy as well as a track record in the implementation of economic reforms. Economic stability reached a degree considered sufficient to allow economic operators to make decisions in a climate of predictability. This has resulted in high growth rates which were on average above 5% in the years preceding the economic crisis. Budget deficit and public debt have been kept at moderate levels. Unemployment has been reduced to below 12% in 2009 and labour legislation modernised. The free interplay of market forces has been developing in the last decade through privatisations and the abolition of controls on prices, foreign exchange and trade regimes. Foreign investments were attracted by the improved business environment. The restructuring process of strategic enterprises and sectors is underway. State aid has been historically low, often related to privatisation clauses or supporting distressed companies. The Montenegrin economy remains very open and the level of trade and investment integration with the EU and the Western Balkan region is high.

However, after years of strong capital inflows supporting rapid economic growth, the global crisis unveiled significant internal and external imbalances exposing the country and threatening macroeconomic stability. The crisis also revealed vulnerabilities in the regulation and supervision of the banking sector, calling for critical recapitalisation of banks. In absence of fiscal space, the government could mainly react by providing guarantees to firms in difficulties, which threaten to materialise in the growing public debt. Persisting unemployment, and informal employment, point to weaknesses in the education and vocational training systems as well as to some labour market rigidities. The country has a still insufficient energy and transport infrastructure. Small businesses in particular are confronted with scarce and expensive financing. Persisting weaknesses in the rule of law negatively affect the business environment. The informal sector remains an important challenge.

## 8. SERBIA

In examining economic developments in Serbia, the Commission's approach was guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 8.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

In January 2010, the government submitted to the European Commission its economic and fiscal programme for the period 2010-12. The programme sets out a revised macroeconomic and fiscal policy framework for the medium term based on the supplementary budget for 2009 and the 2010 budget that were both adopted by parliament in December 2009. Overall, the programme is an appropriate medium-term policy document, presenting a realistic macro-fiscal scenario that is broadly consistent with the country's reform agenda.

Serbia's macroeconomic policy has been anchored by the economic programme supported by the International Monetary Fund (IMF) under the Stand-By Arrangement (SBA) since early 2009. Pursuant to the SBA requirements, a number of fiscal measures were implemented throughout 2009 and in early 2010. Notwithstanding a number of adjustments, including an upward revision of fiscal deficits in 2009 and 2010, the SBA has been on track. The government made significant strides towards enhancing fiscal responsibility by adopting amendments to the budget system law and a new pension bill. However, comprehensive structural reforms that would gear the economy towards a more sustainable path will need to be further pursued and implemented.

Overall, macroeconomic stability was broadly preserved against the backdrop of the global crisis owing to the adoption of timely measures in agreement with the IMF. There is consensus on the fundamentals of a market economy. Medium-term fiscal and structural reforms will have to be implemented without delay to enhance the resilience of the economy.

#### Macroeconomic stability

In 2009, Serbia's GDP shrank by 3% in real terms as a consequence of the global economic crisis, interrupting a period of steady growth with an annual average rate of 6% recorded between 2005 and 2008. The 2009 average per capita GDP in purchasing power standards stood at 37% of the EU-27 average, up marginally from the year before. The recovery has been under way since early 2010 but the pick-up in economic activity has been slower than expected, prompting the IMF and the national authorities to revise downwards their initial GDP growth projection from 2% to 1.5%. While economic growth in the past was driven by domestic demand, it has been recently fuelled more by export expansion. This shift remains to be sustained, based on the strengthening industrial production. While in 2009 industrial output was some 12% lower than the year before, with manufacturing recording the sharpest fall, the negative trend has reversed in 2010. Overall, the Serbian economy continues to be affected by the global economic crisis while recovery has been slow and fragile.

In 2009, international trade and financial transactions were significantly affected by the global economic and financial crisis. At 5.8% of GDP, the current account deficit was considerably lower compared to levels of 10-18% in previous years. This was mainly due to a sharp decline in imports as well as an increase in net inflows of remittances. As imports fell faster than exports the merchandise trade deficit also narrowed as compared to past levels of above 20%. However, at 15.5% of GDP it remained substantial. In 2010, as the international economic environment improved, Serbia's external position stayed solid. In the period to September, the trade deficit was narrowing compared to last

year on the back of vigorous export growth as exports of intermediate goods soared following the revived industrial activity in the EU, Serbia's main trade partner. Annual import growth turned positive in May following a marked pick-up in imports of energy, partly due to the higher international oil prices, and intermediate goods against the backdrop of a gradual recovery in domestic production while investment activity was subdued.

Table 8.1:

**Serbia - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	5.6	5.2	6.9	5.5	-3.1	1.2
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Unemployment	%	21.8	21.6	18.8	14.7	17.4	19.5*
Employment	Ann. % ch	0.4	-1.4	-1.2	0.1	-4.6	-5.4
Wages	Ann. % ch	6.8	11.3	15.0	4.5	1.0	2.4
Current account balance	% of GDP	-8.4	-12.4	-16.1	-18.8	-6.2	-6.3
Direct investment (FDI, net)	% of GDP	5.9	14.6	6.4	5.6	4.2	3.0
CPI	Ann. % ch	N.A.	N.A.	11.0	8.6	6.6	4.3
Interest rate (3 months)	% p.a.	17.22	13.46	6.48	4.98	13.51	9.50*
Stock markets	Index	1,737	2,186	4,096	2,604	1,197	1,330
Exchange rate RSD/EUR	Value	83.25	83.91	79.90	81.94	94.08	100.66
Nominal eff. exchange rate	Index	92.4	103.2	99.6	97.1	94.0	93.6
General government balance	% of GDP	1.0	-1.6	-1.9	-2.4	-4.1	-3.3*
General government debt	% of GDP	50.5	39.8	30.0	25.3	31.3	34.1

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Financial and capital flows remained modest. In 2009, foreign direct investment (FDI) fell by a quarter compared to a year earlier, to €1.37 billion, accounting for 4.3% of GDP. At the same time, long-term borrowing by the corporate sector at €600 billion was only a quarter of the 2008 level while short-term borrowing at €200 million was down by almost 60% on the year before. Notwithstanding the slowly recovering economic activity as of 2010, foreign currency inflows have remained subdued. Over the eight months to September, FDI and other investments were substantially lower than a year ago. The capital and financial account increased as a consequence of domestic commercial banks resorting to additional long-term borrowing while hefty repayments by corporate sector of the pre-crisis foreign loans and an outflow of cash and deposits have been taking place. Still, total foreign exchange reserves remained largely stable during 2010 at over €11 billion, i.e. more than a third of GDP or sufficient to cover some 10 months' worth of imports. Serbia's foreign debt has been increasing since 2009 while capital inflows have been largely insufficient to cover the current account deficit. By end-July 2010, gross external debt had risen by around €0.5 billion since the beginning of the year, to €23.3 billion, i.e. close to 80% of projected GDP. Overall, the Serbian economy saw a substantial external adjustment in 2009 reflected in a considerably narrower current account deficit as well as a lower merchandise trade deficit compared to past levels. In parallel, foreign exchange reserves were built up and are now maintained at a comfortable level. External debt is, however, high and growing indebtedness remains an issue of concern.

The unemployment rate in 2009 increased to 16.1%. 2009 saw significant wage moderation owing also to the nominal freezing of salaries in the public sector, with nominal wages increasing by 6.9% on average compared to 17.9% a year earlier. Moreover, real wage growth slowed to only 0.3% per annum, which was substantially lower than in 2007 (19.5%) and 2008 (3.9%). While economic activity has been picking up gradually, the situation on the labour market has worsened in 2010. In the first half of the year, employment continued to fall in annual terms, with the number of employed persons dropping to historic lows at 1.85 million. According to the national labour force survey of April 2010, the unemployment rate soared to 19.2%. The poor labour market performance has further undermined the social conditions. Wage growth has remained broadly constrained during 2010. In the period from January to July, the average net wage increased compared to the same period last year, by

6.7% in nominal and 2.5% in real terms. Overall, under the impact of the economic crisis labour market conditions deteriorated as employment fell and unemployment approached 20%. Salaries remained almost unchanged in real terms.

The current monetary policy framework has been in place since January 2009 when the National Bank of Serbia (NBS) committed itself to price stability based on consumer price index (CPI) inflation instead of core inflation. The NBS's target was to keep annual CPI inflation between 6% and 10% throughout 2009. At end-December 2009, CPI inflation stood at 6.6%, largely in line with the projections, bringing the yearly average inflation rate of 8.1% well within the target band. In 2009, inflation was largely fuelled by an increase in administered prices of oil derivatives and communal services. For the end of 2010, the NBS set the inflation target band at between 4% and 8%, where the main contribution to overall price growth would come from the rise in regulated prices and excise duties. Disinflation was on track in the first half of the year. However, inflationary tensions were rekindled by rising food prices and the dinar depreciation. The renewed pressures were also based on the expected strengthening of domestic demand in line with the gradual pick-up of economic activity and higher bank lending. The acceleration of inflation prompted the NBS to discontinue the course of a gradual relaxation of monetary conditions. Since the second half of 2009, the key reference interest rate was cut in a number of consecutive steps from its October 2008 peak at 17.75% to 10% by end-December 2009, and further to 8% by early May. Following the two latest rate hikes, the interest rate currently stands at 9%. Overall, disinflation has remained the key policy objective, but price developments need to be monitored carefully as further inflationary pressures might be generated by the increases in regulated prices of energy, gas and oil as well as the pass-through effect of the depreciating dinar.

Since late 2009, the NBS has been actively engaged in preserving exchange rate stability. As the pace of the dinar depreciation in December 2009 was deemed to undermine the process of economic stabilisation, the NBS started intervening again in the interbank foreign currency market. After two interventions at the end of the year, the operations became more frequent in 2010, especially from mid-May when the pressure on the exchange rate again intensified. Despite the NBS's interventions, the dinar continued to slide, rising to RSD106.2 per euro at end-September, i.e. losing about 10% of its value since the beginning of the year. By then, the NBS had sold more than €2 billion in total with the aim of buffering extreme daily fluctuations in the dinar's value. Overall, the dinar has been on a depreciating trend since December 2009. In line with the policy of preventing excessive volatility of the exchange rate, the NBS's interventions on the interbank market were considerable in the first half of 2010 and have, in practice, somewhat overshadowed its inflation targeting policy.

The year 2009 saw a shift in the fiscal stance as the expansionary policy of 2007 and 2008 became constrained by the SBA programme requirements. Ad hoc short-term measures were introduced to mitigate the sharp deterioration of public finances during the economic recession, resulting in two 2009 budget revisions. The consolidated fiscal deficit in 2009 widened to 4.1% of GDP from 2.4% of GDP a year earlier. A set of emergency expenditure measures only partly compensated for the sizeable revenue shortfall. The fiscal adjustment came largely from restricted hiring in the public sector and a nominal freeze on public sector wages and pensions. Capital expenditures were again reduced in comparison with a year earlier. Extensive lay-offs in the private sector and salary freezes in the public sector translated into a shortfall in personal income tax revenue. Furthermore, VAT plunged due to restrained domestic demand. Because of the drop in imports and also the lowering of tariffs following the start of implementation of the trade agreement under the SAA, customs revenues were much lower compared to past years. Conversely, excise taxes increased as a consequence of the hike in excise duties on diesel and gasoline. During 2010, public finances remained under pressure as the fiscal policy allowed automatic stabilisers to operate. In agreement with the IMF, Serbia announced a supplementary budget to allow for a higher budget deficit in 2010. At 4.8% of GDP, the deficit would be the highest in the past decade, but driven by lower-than-planned public revenue rather than growing public expenditure. However, in the period to September public spending was contained



largely through a significant cut in capital expenditure, while current expenditure, accounting for the bulk of total outlays, was in line with the plan against the freeze of public administration salaries and pensions. As of 2009, public debt has been increasing steadily and stood at close to €11 billion, i.e. some 36% of GDP, at end-August. With the aim to strengthen fiscal discipline, Serbia adopted the amendments to the budget system law. These amendments introduce a set of quantitative fiscal rules to underpin fiscal consolidation over the medium term. Furthermore, improved procedures as well as the setting-up of a fiscal council are deemed to anchor fiscal responsibility. However Serbia still needs to adopt the new pension law which, for the purpose of strengthening public finances in the long run, includes an extension of working period and age for assuming pension rights as well as adjustments to the indexation mechanism. Overall, given the adverse impacts of the economic crisis and despite the ad hoc fiscal adjustments, the 2009 budget deficit was substantially higher than in previous years. The corrective short-term measures will need to be backed up by full-fledged systemic reforms, such as reform of the pension and healthcare systems, to improve fiscal sustainability in the medium to long term.

Expansionary fiscal policy and the increasing gap between savings and investment of the private sector, which fuelled external imbalances in the years prior to the 2009 economic downturn exacerbated the economy's vulnerabilities to adverse shocks such as a global recession. The negative effects of the last crisis have been partly cushioned by the economic measures implemented under the IMF SBA programme. However, the macroeconomic policy mix has proven rather limited in responding to the crisis. Effectiveness of monetary policy has been restricted given the high degree of euroisation and the NBS effectively pursuing dual objectives, i.e. smoothing the exchange rate depreciation while being committed to inflation targeting. Moreover, counter-cyclical fiscal policies, which would have been necessary in the period of low economic activity, could not be implemented. This was due to the pre-crisis fiscal expansion and the low capital market integration. To broadly preserve the stability of its economy, Serbia had to apply budget tightening measures, including expenditure cuts, which tend to operate pro-cyclically in such circumstances. Overall, the economic policy mix in place has proven limited in facing the crisis. However, the accompanying policies and measures agreed with the IMF under the SBA programme have provided an adequate response towards the most pressing negative macroeconomic effects.

### Interplay of market forces

The price liberalisation process slowed down in 2009, with the share of administrative prices still representing about a quarter in the CPI inflation basket. The market formation of prices was challenged in mid-2010 as the state intervened following the shortage of basic food items such as dairy and cooking oil. The share of the private sector remained small, accounting for 55-60% of total output and about 60% of the total number of employees. Finalisation of the process of privatisation and/or liquidation of socially and state-owned enterprises remains one of the key priorities of the European partnership for Serbia.

Privatisation of the socially owned companies continued in 2009 but at a slower pace as only 95 such companies were sold. Privatisation proceeds amounted to about €81 million. By the end of 2009, the total number of companies privatised through tenders and auctions, since the start of the process in 2002, had risen to over 2,300, with privatisation revenue totalling about €2.6 billion. The least attractive companies remain unsold. The number of privatisations annulled — due to non-compliance with the contracted obligations — rose to almost one quarter of the firms initially scheduled for privatisation. The government extended the deadline for finalising privatisation of the socially owned companies to 30 June 2011. Overall, progress in selling socially owned companies was limited, while the number of revoked privatisation deals increased.

Given the economic circumstances in 2009, privatisation of the large state-owned companies was delayed. As the situation in the global markets gradually improved, the government announced

privatisation strategies for a number of companies. A few were slated for sale by the end of 2010. Privatisation of the pharmaceutical company Galenika failed, however, and has been postponed. The initial procedures were launched for the telecoms incumbent Telekom but the tender had not been called by the end of September, as planned. As regards the sale of the national air carrier JAT Airways, the government decided to establish a new national airline company that will take over the assets and some of the staff. The debt estimated at €146 million (€25 million in 2009 alone) would be left to the old company, which will remain in state ownership. To facilitate the sale of the remaining state-share in the oil company NIS, the government distributed free shares to the population in mid-2010 and announced further distributions (Belgrade Airport, Telekom, the electricity operator EPS). Privatisation of about 500 utilities in the local communities is outstanding. Their restructuring and reorganisation has not yet begun and the strategy for privatising them remains undefined. Overall, limited progress was made in finalising the privatisation process. Privatisation of socially owned companies has advanced but in the meantime a number of privatisation deals have also been cancelled. State-owned companies have not initiated the restructuring.

### **Market entry and exit**

In 2009, some progress was made in facilitating market entry. The number of registered companies stood at 113,000 in May 2010, up from 106,000 in April 2009. At the same time, about 225,000 entrepreneurs were registered with the Serbian Business Registry Agency, i.e. around 5,000 more than a year earlier. The one-stop-shop system for registering a company has been in place since May 2009. It now takes on average 5 instead of 23 days to register and has been estimated to significantly lower administration cost for companies. The Agency has also further extended the number of registers, including the Registry for Financial Statements, which will do away with the past practice of multiple submissions of these statements to various state bodies. Nevertheless, further efforts are needed to improve the conditions for starting-up a business, particularly in the area of construction permits, where implementation of the new Law on planning and construction from 2009 has been very slow. With regard to market exit, a new Bankruptcy Law came into effect in January 2010 but the number of pending cases remains very high. Overall, there has been some progress, particularly regarding the registration of new companies and submission of the financial statements of those already operating. However, excessive red tape and complex legislation remain in place and continue to hamper the business environment.

### **Legal system**

Some progress was observed in adopting new legislation in line with the *acquis*. However, preparation and implementation of the laws are sometimes slow and uneven. Also, legal enforcement is weak due to technical and personnel shortcomings in the courts and administrative bodies. Inconsistent implementation of laws and very lengthy procedures, which frequently exceed the deadlines set by law, hinder investment. Overall, weaknesses in the rule of law and prevalent corruption continued to limit legal predictability and undermined trust in the legal system among economic operators, in particular as regards effective enforcement of property rights.

### **Financial sector development**

The number of banks decreased from 34 to 33 after the merger of two state-owned banks in September 2010. There are now 3 majority state-owned banks, holding a 2.6% market share. Foreign ownership has risen to almost 75% of the total banking sector and currently 21 out of 33 banks operating in Serbia are owned by foreign entities. Subsidiaries of Austrian, Greek and Italian banks are within the top five banks in terms of assets and together control almost 60% of the market. Domestic private banks are small with only one of them among the top 10 banks.

Serbia's financial sector has been relatively unscathed by the international financial crisis. In line with the agreement reached in March 2009 ('Vienna Initiative'), the parent commercial banks having subsidiaries in Serbia maintained their exposure in the Serbian market at the pre-crisis level and effectively increased their capital adequacy ratios in 2009. Given the positive results of the economic stabilisation programme, it was agreed that exposure commitments could be reduced as of April 2010, from 100% to 80% of the end-2008 exposure as a first step towards phasing-out of the initiative. Deposits, of which 70% are in foreign currency, represent almost 60% of the total liabilities of the banking sector. Similarly, loans account for some 60% of banking sector assets. Over three quarters of loans are denominated in foreign currency or are foreign-currency linked, predominantly in euros. More than half of the loans are granted to the corporate sector (mainly to trade and industry — around 20% each) while about a third is for households. Since the crisis credit growth for the private sector has decelerated substantially and the government has put in place a support scheme to subsidise commercial bank loans to companies and households.

Capitalisation of the banking sector is high. The average capital adequacy ratio stands at 21% while all systemic banks maintain it above the prescribed minimum of 12%. However, the asset quality of the banking sector has worsened, with a rise in bad loans since 2009. The gross non-performing loans ratio peaked at 17.5% by the second half of 2010. A systemic liquidity crisis is unlikely as liquid assets accounted for over 36% of total assets at end-June. The NBS can release ample amounts of liquidity by further relaxing relatively high reserve requirements, which were introduced with the aim to limit rapid credit growth prior to the crisis. The high capital and reserve requirements have been partly responsible for the generally low profitability of the Serbian banking sector by regional standards. Stress tests for 31 banks carried out in 2010 concluded that banks are sufficiently resilient to further adverse shocks but remain vulnerable to credit risk. The weak performance of the corporate sector in the face of the slow economic recovery may raise defaults in the servicing of loans. Furthermore, there is some exchange rate risk on the borrowers' side given the high degree of euroisation of Serbia's economy. Overall, financial intermediation growth has slowed down against the backdrop of the economic downturn. The banking sector remained generally sound and profitable, but a close watch needs to be kept for possible deterioration in the repayment capacity of borrowers due to the relatively high share of bad loans and considerable exposure to exchange rate risk.

At the end of 2009, there were 26 insurance companies operating in Serbia, up from 24 a year earlier. 19 insurance companies are in majority foreign ownership while 7 rely on predominantly domestic capital. The recession has impacted the performance of the sector, with premium income having risen only by 2.6% on the year in 2009. The insurance sector's share of capital in the total financial sector dropped to 3.9%. Overall, progress in development of the non-banking financial sector slowed down and consequently its size in financial intermediation remained limited.

## **8.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

### **Existence of a functioning market economy**

The overall economic climate deteriorated in the face of the global crisis but the authorities have succeeded in broadly maintaining macroeconomic stability to support the continued transition to a market economy. In particular, the monetary authorities applied timely and adequate measures to restore trust in the banking system. On the fiscal side, the corrective short-term measures will need to be backed up by full-fledged systemic reforms to ensure fiscal sustainability in the medium to long term. The adoption of the fiscal responsibility legislation is an important step, which paves the way towards bolstering fiscal discipline. Pension reform will also contribute to the long-term sustainability of public finances. However, the weak corporate governance and the deficiencies in competition continue to be barriers to business. Overall, in the more challenging

environment the previously identified handicaps have become more acute. Market mechanisms remained hampered by distortions, legal uncertainty, heavy state involvement in production, and insufficient competition.

### **Human and physical capital**

Some progress was observed following the accelerated reform of the education system, which is poised to better meet labour market demand. Nevertheless, the gap between demand for and supply of skilled workforce identified in previous reports continues to be a drag on FDI and the development of new segments of the economy. The attitude towards lifelong learning and mobility has been improving, albeit at a rather slow pace. Public education expenditure accounted for 3.3% of GDP in 2009, lower than the planned 3.9%. Overall, the economy continues to suffer from a shortage of skilled labour while supply has been only gradually adjusting to market needs.

In 2009, investment activity was constrained and the private investment rate dropped to 20% of GDP. Net FDI fell by almost 25% on the year before, to €1.37 billion, bringing the cumulative inflow since 2000 to €12.2 billion. The three sectors receiving most FDI were financial intermediation, manufacturing, and transport and telecommunication. However, a large share of FDI was destined to the non-tradable sectors of the economy, which contributed to the increasing external imbalances. In 2009, domestic investment dwindled. The funds of the National Investment Plan were slashed to €210 million, a third of the 2008 amount, and were used for various projects related to the development of communal and road infrastructure in the 40 least developed municipalities but also in support of industrial hubs (such as Kragujevac) along Corridor X, as well as for construction of social housing. For 2010, the National Investment Plan was further reduced to about €100 million. Overall, domestic investment has been declining as local sources have been scarce and FDI has also lost momentum given the globally unfavourable economic conditions.

### **Sectoral and enterprise structure**

The restructuring process has advanced only slowly. The shift of economic activity towards the service sector has stabilised, with services contributing more than 60% of GDP. The public companies still generate a large part of Serbia's output. However, their performance has been undermined considerably by the crisis, with the erosion of capital and the accumulated loss rising to €3 billion, i.e. more than a quarter of their total capital at end-2009. The private companies account for a smaller share of production but the bulk of foreign trade. Around 75% of Serbia's export is undertaken by companies in predominantly foreign ownership. Small and medium-sized enterprises contribute for just over 51% of the total value-added and slightly more than 57% of the overall employment. The informal sector, fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime, remains large. It reduces the tax base and the efficiency of economic policies. Overall, structural adjustment of the economy has been lagging on the back of the slow reform process, which has been hampered by the economic crisis. The informal sector remains an important challenge.

### **State influence on competitiveness**

State subsidies were relatively high at around 2.2% of GDP in 2009 following a nominal increase of almost a quarter compared to 2008. The amount of subsidies could be underreported as the state schemes as well as the individual state aid are not systematically referred for prior approval. The legislation on state aid control from July 2009 needs to be effectively enforced by the recently established State aid authority, but an appropriate monitoring mechanism is still missing. The state-controlled monopolistic structures remain in place. Overall, the state continues to influence substantially on competitiveness through its legal and financial mechanisms.

### Economic integration with the EU

The EU has remained Serbia's main trading partner, accounting for 58% of the country's total exports and 57% of the total imports. The negative trade gap which Serbia had with the EU was declining steadily in the period to August 2010. Serbia also continued to improve a trade surplus with the countries in the region. The CEFTA countries account for 16% of Serbia's trade.

Export price competitiveness improved in 2009. Real gross wage growth at 0.2% was considerably smaller than average labour productivity growth, which translated into a 3% fall in real unit labour costs. In real effective terms, the dinar lost 3% of its value, despite consumer prices growing faster on the domestic market than abroad on average. In the first half of 2010, the real effective exchange rate of the dinar weakened further by some 7%. Against the background of subdued wage growth and increasing unemployment, unit labour costs continued to drop in real terms. Overall, trade integration with the EU remained high and export competitiveness continued to improve.

### 8.3. Conclusions

Following a severe recession in the wake of the global crisis, Serbia's economy gradually recouped stability as a result of an adjustment programme agreed with the IMF and also supported by the EU and the World Bank. As of the first half of 2010, economic activity has been picking up but recovery remains slow and fragile. Public finances continued to deteriorate despite a number of fiscal adjustment measures put in place to contain the budgetary slippage. Adoption by government of amendments to the budget system law and the pension law was an important step towards improving the quality of public finances. Other structural reforms, especially privatisation and enterprise restructuring, have been again delayed due to protracted unfavourable market conditions.

As regards the economic criteria, further progress towards establishing a functioning market economy has been limited. Serbia needs to make more efforts in restructuring its economy so as to cope in the medium-term with the competitive pressures and market forces within the European Union.

There is broad consensus on the fundamentals of a market economy. The adoption of timely and appropriate measures in agreement with the IMF was key in re-establishing macroeconomic stability. Serbia's external position improved during the recession. The pick-up in economic activity in 2010 led to a widening of the current account deficit which was, however, limited on the back of strong export and subdued import growth. Foreign exchange reserves remained relatively high despite regular interventions by the central bank to buffer volatility of the exchange rate. Inflation was broadly maintained within the target band as the central bank reverted to restrictive monetary policy. The banks continued to be adequately capitalised and liquid. Amending the budget system law and the pension law commits the government to fiscal consolidation over the medium-term.

However, Serbia has further postponed the reforms to tackle the biggest structural shortcomings. Despite a gradual economic recovery, the labour market has continued to deteriorate, with decreasing employment and increasing unemployment. Notwithstanding the corrective measures to limit the fiscal slippage during the crisis and the amended budget system and pension legislation to enhance fiscal discipline, the public finance sustainability in the medium term needs to be strengthened by reforms in the areas of healthcare system and public administration. Privatisation of the socially-owned companies has back-paddled following repeal of numerous sale contracts. Privatisation of the state-owned companies has been further delayed. The business environment continues to be constrained by red tape and weak legal predictability, in particular with respect to effective enforcement of property rights, which hamper market entry and exit. Furthermore, deficiencies in competition and infrastructure bottlenecks remain barriers to doing business. The informal sector remains an important challenge.

## 9. KOSOVO (UN 1244)

In examining the economic developments in Kosovo, the Commission's approach is guided by the conclusions of the European Council in Copenhagen in June 1993, which stated that membership of the Union requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

### 9.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

#### Economic policy essentials

In April, the government of Kosovo adopted its medium-term expenditure framework (MTEF), covering the years 2011-2013. In July, an agreement was reached with the IMF on an 18-month programme supported by a €109 million Stand-By Arrangement (SBA). Subsequently, the MTEF's fiscal scenario was updated and brought into line with the IMF agreement. The fiscal deficit targets for 2010 and 2011 did not change substantially but revenue and expenditure estimates were adjusted and made more realistic. Some new legislation is submitted to the government with no link to the MTEF. The fiscal surveillance mechanism with the European Commission continued with meetings being held on a bi-annual basis. Overall, political consensus on the fundamentals of market-oriented economic policies has been maintained. However, the consistency of policy formulation and implementation needs to be reinforced and the link between policy priorities, structural reforms and public expenditure remained weak.

#### Macroeconomic stability

The international economic and financial crisis had a limited impact on Kosovo's economy. The main effect has been a drop of remittances, and reduced external demand and prices for Kosovo's main exports. Real GDP growth decelerated from 5.4% in 2008 to 4.0% in 2009. In 2008, growth was driven by government investment and private consumption. However, in 2009 and the first half of 2010 growth was almost entirely driven by government consumption and investment. Private consumption growth was subdued at 2.1% in 2009, whereas government consumption grew by 16.4%. Nevertheless, their shares in GDP remained almost unchanged, at close to 95% and 18%, respectively. After more than doubling in 2008, government investment continued to grow robustly by over 30%, reaching about 10% of GDP, while private investment recovered from a slump in the previous year and expanded by a real 5.0% in 2009. The donor sector continued to wind down its share in the economy. Imports of goods and services grew by a real 3.5% and declined in nominal terms due to a strong price effect. Exports decreased by 1.8%, mainly because of reduced foreign demand and lower international prices for base metals and articles made from base metals. Though their availability improved somewhat over the year, economic statistics still remain weak and do not allow a comprehensive assessment of the economic situation in Kosovo. GDP per capita reached €1,790 in 2009, equal to 7.6% of the EU-27 average compared with 7.1% in 2008. Overall, Kosovo's economic growth was mainly driven by increased government expenditure. There are growing risks to the sustainability of this growth profile.

Exports of goods started to recover in the final months of 2009 thanks to the reopening of the second production line of Ferronikeli, the lead and zinc mining and processing company, which is Kosovo's biggest exporter. For the whole year exports reached 4.2% of GDP but were still below the 5.1% recorded in 2008. In the first seven months of 2010 exports of goods increased by a nominal 107% over the same period last year. Imports of goods fell marginally to 49.6% of GDP in 2009, down from 50.2% in 2008. Their structure has changed, shifting from consumption goods to machinery and transport equipment, largely linked to accelerated public infrastructure spending. By the end of July 2010, imports of goods posted a 12.3% nominal increase with more than three quarters of commodity groups registering positive growth rates.

The coverage ratio of exports of goods as a percentage of imports (12-month moving average) has increased since it bottomed out at 7.8% in September 2009 and stood at 12.1% in July 2010, still extremely low. Compared to a deficit of 43.4% of GDP in 2008, the trade balance improved slightly in 2009, posting a deficit of 43.3% of GDP. From January to July 2010, the trade deficit increased to EUR 992 million compared to EUR 949 million in the corresponding period of the previous year, as gains on the exports side were more than offset by increased imports.

Table 9.1:

**Kosovo - Main economic trends**

		2005	2006	2007	2008	2009	2010 H1
Gross domestic product	Ann. % ch	3.8	3.9	3.9	5.4	4.0	N.A.
Private consumption	Ann. % ch	7.5	4.3	8.9	5.8	2.1	N.A.
Investment	Ann. % ch	-6.1	1.3	3.9	15.5	13.1	N.A.
Unemployment	%	41.4	44.9	43.6	47.5	45.4	N.A.
Employment	Ann. % ch	-1.1	-10.1	8.1	-12.9	N.A.	N.A.
Wages	Ann. % ch	8.5	N.A.	N.A.	N.A.	N.A.	N.A.
Current account balance	% of GDP	-7.4	-6.7	-8.8	-16.0	-18.6	N.A.
Direct investment (FDI, net)	% of GDP	2.6	9.1	12.6	8.9	7.8	N.A.
CPI	Ann. % ch	-1.4	0.6	4.4	9.4	-2.4	1.4
Interest rate (3 months)	% p.a.	15.60	15.38	15.25	16.61	14.11	17.36*
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
Real eff. exchange rate	Index	-5.0	-2.8	-0.1	N.A.	N.A.	N.A.
General government balance	% of GDP	-3.1	2.5	7.1	-0.2	-0.8	N.A.
General government debt	% of GDP	N.A.	N.A.	N.A.	N.A.	6.5	N.A.

\* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

In 2009, the current account deficit (including official transfers) widened to 16.4% of GDP from 15.7% in 2008. The increase in the deficit was driven by a lax fiscal policy, poor exports of goods performance and by a severe reduction in the income account, which dropped by more than half – from 4.0% of GDP in 2008 to 1.8% in 2009. The main factor contributing to the worsening of the income account was the drop in net investment income. Workers' remittances and official transfers totalled 12.9% and 6.4% of GDP respectively. The surplus on the capital and financial account (12.7% of GDP) was not enough to cover the current account deficit in 2009 and, as a result, reserve assets declined by €154.0 million. The capital account posted a surplus of 2.6% of GDP – a tenfold increase over the previous year, mainly because of repayment of World Bank debt with the help of substantial donor support. Net foreign direct investment dropped by 19% to 7.1% of GDP. Portfolio investments (-1.5% of GDP) and loans (-1.9% of GDP) turned negative. Net errors and omissions remained significant at 2.9% of GDP, illustrating that the balance of payments statistics do not capture properly all inflows and outflows from the country. Overall, external imbalances remained significant and their financing led to a reduction in reserves as net capital inflows declined.

Unemployment in 2009 remained very high and stood at 45% according to the Labour Force Survey. In the first half of 2010, the number of registered unemployed shrank by 0.2% compared with the first half of 2009. This drop was driven by the decrease in semi-skilled and skilled unemployment, whereas unskilled unemployment increased on average by 0.3%. By the end of June 2010, unskilled unemployed accounted for 60% of total registered job seekers. An estimated 30,000 young people, mostly low-skilled, enter the labour market every year without many employment opportunities and chances of professional development. Labour continues to be Kosovo's most important export item which generates an inflow of remittances financing a large share of domestic consumption. Information about the labour market remained scarce and doubts about its accuracy persist. Moreover, official data do not provide a sound picture of the labour market given the high share of informal employment. The time lag between publication of labour force survey data and the reporting period has been shortened and the latest survey, covering 2009, was published in July 2010. There have been some positive developments, like increased participation and employment rates. However, the employment rate was only 26%, and youth and long-term unemployment remained particularly high,

at 73% and 82% of all unemployed. The structure of employment shows that labour has shifted mainly towards non tradable sectors – some 17% were employed in trade, 13% in education, 10% in administration, 8% in construction and only 10% in manufacturing. Overall, in spite of positive growth, the economy is not creating enough jobs to absorb the young new entrants and reduce pressures on the labour market. Unemployment remains very high.

Annual inflation in 2009 was negative at -2.4%. Monthly inflation rates became positive by the end of 2009 and since then accelerated to reach 5.9% (year-on-year) in August 2010 when there was a pronounced spike due to surging bread prices. Bread and cereals prices alone contributed 2.3 percentage points to the headline inflation. By the end of August, the goods and services with positive contribution to inflation had a total weight of close to 75% in the whole CPI basket. The surge in this indicator over the summer months thus reflected more broad-based inflationary pressures. Consumption patterns were focused on tradable goods and services, which make up about three quarters of the CPI basket. Overall, inflation remained volatile, mainly because food and fuel prices weigh heavily in the calculation.

Kosovo is using the euro as official currency and the Central Bank of Kosovo (CBK) has only limited policy instruments. The growth in broad money decelerated from 23.6% in December 2008 to 11.2% in December 2009 and even turned negative after May 2010, following a substantial reduction in public non-financial corporations' deposits. The monetisation of the economy, measured by the ratio of average broad money to GDP, increased from 32.4% in 2008 to 38.0% in 2009. The central bank's efforts were directed mainly towards improving its supervision of the financial sector. In June, the Law on the Central Bank was revised to strengthen CBK's independence and accountability and open up the possibility of limited emergency liquidity assistance. Overall, the monetary framework continued to function well and financial stability was preserved.

The budget deficit increased from 0.2% of GDP in 2008 to 0.8% in 2009. The underlying deficit was, however, much higher, rising to about 6.0% of GDP in 2009, if a one-off €200 million dividend payment received from Post and Telecommunications of Kosovo (PTK) is taken into account. Total revenue (excluding the PTK dividend) remained unchanged from 2008 at 24.5% of GDP. Total expenditure increased by a nominal 24.1% to 30.5% of GDP in 2009. Spending on wages and salaries was up from 5.9% of GDP to 6.8%, driven by salary rises for public employees. As a result of a better execution rate for investments and an additional loan to support the Kosovo Energy Corporation (KEK), capital expenditure and net lending rose from 7.6% of GDP to 11.7%. Government deposits at the central bank dropped from €414 million (10.8% of GDP) in 2008 to €342 million (8.8% of GDP) at the end of 2009. In December 2009, the Assembly adopted a law on public debt, which placed limits on state and municipal borrowing. In no event shall the total debt (guarantees included) exceed 40% of GDP. In 2009, Kosovo assumed obligations towards the World Bank, which stood at 6.4% of GDP at the end of December. Total government debt, including recognised international debt and borrowing from the IMF, stood at 6.8% of GDP at the end of August 2010. A debt management unit has come into operation within the Treasury of the Ministry of Economy and Finance.

In 2010, a dividend payment was received from PTK, of €80 million, after the one of 2009. By the end of August, the underlying revenue growth, net of dividends, was a nominal 13.4%. It was underpinned by a strong performance of border and domestic taxes collection. The expenditure growth pattern remained unchanged and capital outlays along with expenditure on wages and salaries kept growing at double-digit rates. The average monthly public-sector net wage increased by 16.4% in the first quarter of 2010 compared with the corresponding period of 2009. Mainly as a result of the one-off dividend payment from PTK, the budget accumulated a surplus of €85 million by the end of August. Overall, the budget faces growing risks, as expenditure is growing much faster than tax revenue, and is increasingly financed by one-off revenue and reduction of accumulated deposits.



Fiscal planning remained ad hoc, with government expenditure initiatives already substantially departing from budget plans and the medium-term expenditure framework by the beginning of 2010. In March, the government awarded a contract for the building of the Vermica-Merdare motorway. This infrastructure priority had not been included in the 2010 budget or the MTEF. The project is estimated at about €1 billion (about 25% of GDP) and is expected to be completed in four to five years. In May, in an attempt to limit fiscal risks – notably those stemming from the motorway project – and revert to fiscal sustainability, a staff-level agreement was reached with the IMF on an 18-month programme, supported by a €109 million Stand-By Arrangement. It was approved by the IMF Executive Board in the second half of July. The fiscal framework was updated in order to incorporate formally the measures agreed under the IMF programme and reflect fully the estimated cost of the motorway construction. To limit the deterioration of the budget deficit, selected excise rates were increased with effect from the beginning of July. The Law on public financial management and accountability was amended to ensure that any spending initiative introduced in mid-year budgetary reviews in 2011 and subsequent years will be fully compensated by credible new revenue measures or offset by expenditure cuts. As a result of the agreement with the IMF, the 2010 deficit target remained almost unchanged at 3.4% of GDP but revenue and expenditure estimates have been adjusted and made more realistic. Overall, policy predictability, consistency and transparency remained a challenge.

Due to Kosovo's relatively low level of integration into the global economy and lax fiscal policy, its economy was largely shielded from the global economic crisis and continued growing in 2009. Economic growth was increasingly driven by government expenditure, while external imbalances remained significant. The importance of fiscal policy for maintaining economic stability increased. The pressure on the labour market did not abate and the economy still faces daunting structural problems. Overall, the macroeconomic policy mix has been effective in sustaining economic stability but is increasingly vulnerable as a result of strong government expenditure growth.

### Interplay of market forces

The Privatisation Agency of Kosovo continued the privatisation of socially owned enterprises, albeit mainly small businesses, with limited macroeconomic impact. At the beginning of 2010, the agency started liquidation of socially owned enterprises for which there is no investor interest in privatisation. Some progress was made with the privatisation of publicly (State) owned enterprises. The government hired a transaction advisor for privatisation of the Post and Telecommunications of Kosovo. The government also hired a transaction advisor for privatisation of the distribution and supply functions of the public electricity company (Kosovo Energy Corporation). This privatisation and the transaction for the development of the new Kosovo power plant have suffered some delays, partly related to the energy market model to be used. Provisions on concessions, under the public procurement law, have not been adopted, which affected the legal environment for these companies. Overall, there has been some progress with the privatisation process, especially concerning publicly owned enterprises.

### Market entry and exit

Online registration of businesses started in June. The Kosovo Business Registration Agency's register now includes about 45,000 active companies (the respective number at the end of 2008 was 67,950) out of a total of around 97,000. Information on registered companies is available online. In 2009, the number of new and re-registered enterprises was about 7,500 and remained almost unchanged over the previous year. A new project to establish one-stop-shop facilities (22 in total) where companies can obtain various licences at the same time started in eight municipalities. Fees for starting and closing a business are low, but the relatively large number of inactive firms in the business register suggests that the market exit regulations and implementation thereof could be improved further. Overall, weak administration and the rule of law, unreliable energy supply, limited access to finance, corruption and poorly defined property rights hinder market entry and exit.

### Legal system

The legal system continued to exhibit poor accessibility and efficiency, and some areas are not covered by relevant courts. There have been some improvements in enforceability of contracts, although informal methods of enforcement continue to be widespread. The situation regarding property rights remains a cause for concern. Only a few municipalities have digital immovable property rights registers. These are not linked to the central land registry and there is a lack of communication between municipal and central authorities. Some land registry books remain in Serbia. In general, the inability of authorities to implement legislation comprehensively remains a major obstacle to protecting property rights. In cooperation with EULEX, the Kosovo courts are in the process of investigating several high-level corruption cases. Overall, the existing legal framework remains underdeveloped and its implementation remains poor. The difficult and costly legal enforcement of contracts and prevalent corruption continued to hamper the business environment.

### Financial sector development

The financial sector expanded by 24.2% in 2009, taking the total value of assets to €2.8 billion or about 72% of GDP. The banking sector is still predominant and accounted for 78.6% of assets, followed by pension funds (13.6%), microfinance institutions (4.7%), insurance companies (2.9%) and financial intermediaries (0.2%). The number of commercial banks (eight) and pension funds (two) remained the same, whereas another three microfinance institutions (taking their number to 19) and one new insurance company (making them 11) started up activities during 2009. The degree of concentration of the banking system has declined but remains high, with 81% of the assets managed by three banks. More than 90% of the assets in the sector are handled by banks under foreign ownership. The net profit of the banking sector decreased by 30.5% in 2009, leading to a lower return on average assets (1.4% compared with 2.4% in 2008) and on average equity (13% compared with 24.7% in 2008). Non-performing loans increased from 3.3% of total loans in 2008 to 4.3% in 2009 but the banking system's capital adequacy ratio remained at a comfortable 18%. Banks have remained profitable in 2010 as well. Their interest income remained buoyant and retained profits increased by about 50% by the end of July. Overall, financial intermediation deepened at a much slower pace while the banking sector remained stable and profitable.

Credit activity continued growing in 2009, albeit more slowly in comparison to previous years. Banking sector loans grew by a nominal 8.9% to reach one-third of GDP in 2009 and expanded by 11.3% (year-on-year) by end-August. In 2009, credit to non-financial corporations grew by 4.6% and credit to households by 22.3%. By end-August, the growth of credit to non-financial corporations decelerated to 4.1%, while credit to households accelerated to 28.5%. As a result, the structure of credit has changed and the share of credit to households increased at the expense of other non-financial corporations, whose share declined by more than 3 percentage points to below 70%. The low level of production and the high dependence of the Kosovo economy on imports were reflected in the sectoral distribution of loans to private enterprises. The services sector continued to attract most of the credit but its share fell by 7 percentage points in 2009 to 70.7% of the credit to non-financial corporations by the end of the year and continued to fall in 2010. Credit to industry, the energy sector and construction has been steadily expanding (47% annual growth in 2009) and reached a quarter of all credit to non-financial corporations. This trend continued in 2010 and by end-August its share was already 28% of all non-financial corporations' credit. The maturity structure of loans improved somewhat and loans with maturity longer than two years increased to 70% of the total loan portfolio in 2009 (up from 62% in 2008).

After increasing by 20.8% in 2009, growth in deposits decelerated to 11.1% (year-on-year) by end-August. Households deposits grew by about 25% and, with a share of 67%, made up the majority of total deposits. By the end of 2009, total deposits increased to 45.1% of GDP from 37.5% in 2008. The loans-to-deposits ratio decreased over the year to 74%, well below the informal benchmark that loans-

to-deposits should not exceed 80%, but then rose again to 78% in August. The annual average interest rate spread between loans and deposits dropped from 10.6% in 2008 to 10.1% in 2009, still very high. This decrease was predominantly driven by a reduction of 0.4 percentage points in the interest rate on loans, as there was only a small 0.1 percentage point increase in the annual average interest on deposits. Nevertheless, average lending rates remained high at about 14.4%. The 12-month moving average spread started to increase again in 2010, on the back of falling deposit interest rates, and stood at 10.4 percentage points in August. As in the previous year, the spread is narrower for loans to households than for loans to non-financial corporations. Overall, commercial banks have become slightly more cautious in their credit expansion and lending conditions remained tight.

## **9.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION**

### **Existence of a functioning market economy**

Macroeconomic stability has been preserved but fiscal and external vulnerabilities have been increasing. The policy mix is increasingly vulnerable as a result of strong government expenditure growth. Unemployment remains very high, revealing deep structural problems in the economy. Inflation remains volatile, with food and fuel prices making a big contribution. Poor governance and ad-hoc policy-making have contributed to a high level of economic uncertainty. Overall, macroeconomic vulnerabilities have increased and deep structural problems continue to hamper the economy. The weak rule of law, corruption, high level of informal activities, poor infrastructure, and a subsidised and unreliable electricity supply, impair the efficiency of market mechanisms.

### **Human and physical capital**

Some progress was made in the education sector with certification of teachers and vocational training. A new teacher licensing system is being set up, along with a Board on vocational education and training to ensure effective modernisation of vocational training institutions in Kosovo. However, education is still hampered by financing constraints, lack of adequate facilities and poor-quality teaching. The Ministry of Education is developing higher education curricula to address demand and skills mismatches on the labour market. Some schools continue to operate on multiple shifts. Their physical condition remains poor as they lack appropriate buildings, teaching material and equipment. The research capacity of universities and research institutes is still very weak. Overall, little progress has been made towards improving the quality of education and there are low incentives for lifelong learning.

Total investment equalled around 26.3% of GDP in 2009, an increase over the previous year 24.4%. Private investment, although increasing in real terms, decreased in absolute and relative terms and its share in total investment dropped by about 10 percentage points to about 60%. The largest share of public investment was channelled into improving the road infrastructure. The sudden decision to start a large motorway project led the government to reconsider its investment priorities. In May, an international consortium was selected to develop the Pristina International Airport under a public-private partnership with a concession for twenty years. Mobile telephony penetration increased to 71% and four mobile operators (two mobile network operators and two mobile virtual network operators) are active on the market. Broadband penetration stands at 6.4%. Overall, there were marginal improvements in the physical capital but the decrease in private investment to a five-year low as a share of GDP could hamper improvement on the supply side.

### **Sectoral and enterprise structure**

Kosovo's enterprise sector remains dominated by micro-enterprises. More than 90% of the enterprises employ less than four people. The economic structure is highly concentrated on the retail sector, with about half of all enterprises operating in this field. A Law on Economic Zones has been adopted and the procedure to establish six zones, one at central and five at municipal level, has started. The informal sector remains large. This is due to weaknesses in tax and expenditure policies, as well as in law enforcement. It reduces the tax base and the efficiency of economic policies. As a measure to combat the informal economy, the tax administration started to issue fiscal numbers and install fiscal cashiers. Providing a reliable electricity supply remains a challenge for private sector development. Despite some improvements in billing and collection in 2009, about 42% of the energy entering the KEK network was not paid for. Overall, there has been almost no change in the enterprise structure and large informalities in the economy persist. The large informal sector remains an important challenge.

### **State influence on competitiveness**

Regulatory authorities remain weak. The new law on mines and minerals as adopted in July seriously undermines the independence of the Independent Commission on Mines and Minerals by handing over responsibility for licensing and the appointment of the chief inspector of the Mining Inspectorate to the Government. The government has proposed to the Telecommunications Regulatory Authority to place a five year moratorium on the issuance of any further mobile telephony licences, which, if approved, would hurt consumer interests and reduce competition in the sector. Budget transfers and subsidies remained unchanged from 2008 at 3.5% of GDP. The public electricity company KEK continues to receive substantial subsidies from the state budget for electricity imports and loans for financing its investment programme. The government took some first steps to address a number of weaknesses in the public procurement system. Overall, the role of the state in the economy has been on the rise.

### **Economic integration with the EU**

The openness of the economy, measured by the value of imports and exports of goods and services as a ratio to GDP, increased to 70.9% from 68.9% in 2008. Exports to the EU Member States showed a steep decline of 24.7%, down from 48% in 2008 to 41.5% of total exports in 2009. This was mainly due to lower external demand and prices for Kosovo's export of nickel. Exports to CEFTA countries declined by 15.3% but their share of total exports remained almost unchanged at 32.0% in 2009. The EU and CEFTA countries remained the main origin for Kosovo's imports, with shares of 38.7% (36.4% in 2008) and 36.1% (37.2% in 2008) respectively. Difficulties related to the recognition of the customs stamps hamper trade with some CEFTA countries. With almost three quarters of the new foreign investment inflows in 2009, the EU countries remain the biggest investors in Kosovo. Overall, economic integration with the EU remained low.

### **9.3. Conclusions**

The impact of the economic crisis on the economy of Kosovo has been limited. Real GDP continued growing mainly driven by public expenditure. There are growing risks to the sustainability of this growth profile. Unemployment remains very high. Inflation has been volatile, reflecting fluctuating food and fuel prices. Policy formulation and implementation continued to lack predictability. An agreement has been reached with the IMF on a programme with the aim to limit fiscal risks and revert to fiscal sustainability. Firms continue to face weak rule of law, the lack of a reliable electricity supply, poor infrastructure and limited access to financing. These are barriers to effective business and economic development.

As regards the economic criteria, Kosovo has achieved limited progress towards establishing a functioning market economy. Considerable reforms and investments are needed to enable it to cope over the long term with competitive pressure and market forces within the Union.

A broad consensus on the fundamentals of market-oriented economic policies has been maintained. The use of the euro, the low levels of external debt and the narrow exports' base have limited the economy's exposure to external financial and demand shocks. The banking sector continued to expand and remained stable and profitable. The Privatisation Agency of Kosovo has continued the privatisation of socially owned enterprises. The first successful public private partnership project has been concluded and an international consortium has been selected to develop the Pristina International Airport under a concession for twenty years.

However, the policy mix is increasingly vulnerable as a result of strong government expenditure growth. In particular, the building of a new motorway weighs heavily on public finances. Deficiencies in policy formulation and implementation have increased the already high uncertainty in the economy. Economic statistics improved somewhat, but still remain inadequate. Unemployment remains very high particularly among the young. The current account deficit has widened due to strong domestic demand and an underdeveloped production base. The public electricity company has continued to receive substantial subsidies from the state budget for the import of electricity and loans for financing of its investment programme. The weak rule of law, uncertainty over property rights and high interest rates continue to impact negatively on the business environment and on economic development. The informal sector remains an important challenge.

## ANNEX 1

### Abbreviations

BiH	Bosnia and Herzegovina
CBBH	Central Bank of Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EFPs	Economic and Fiscal Programmes
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross domestic product
HRK	Croatian Kuna
ILO	International Labour Organization
IMF	International Monetary Fund
KTA	Kosovo Trust Agency
MTEF	Medium-Term Expenditure Framework
PAK	Privatisation Agency of Kosovo
PEPs	Pre-Accession Economic Programmes
PRGF	Poverty Reduction and Growth Facility
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SMEs	Small and Medium sized Enterprises
SOEs	Socially owned enterprises
UNMIK	UN Interim Administration Mission in Kosovo