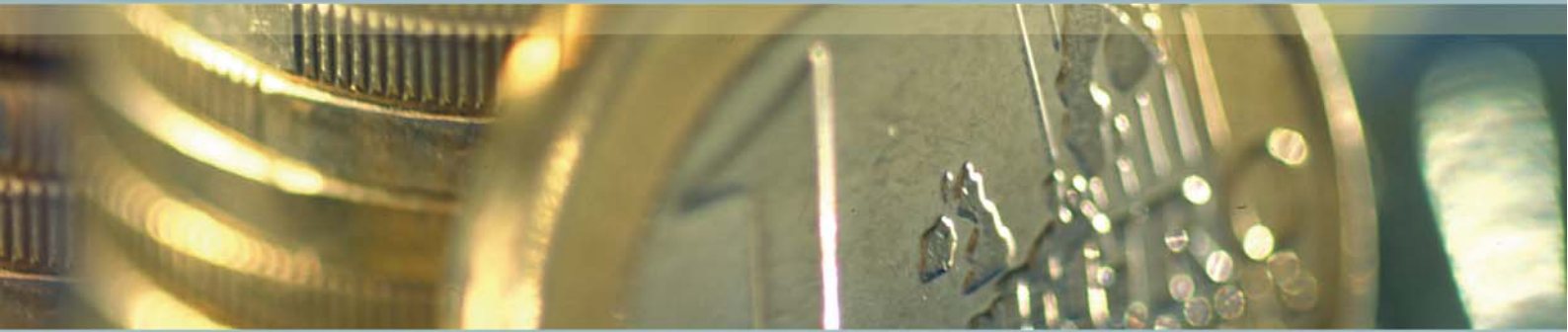


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Progress towards meeting the economic criteria for accession: the assessments of the 2011 Progress Reports and the Opinion (Serbia)

Directorate-General for Economic and Financial Affairs

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European Commission

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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 2011 European Commission's Progress Reports and Opinion 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, Montenegro and Turkey as well as for the potential candidate countries Albania, Bosnia and Herzegovina and for Kosovo¹. It also prepared an opinion on Serbia. The European Commission adopted the Progress Reports and Opinion on 12 October 2011.

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 2011 Progress Reports and Opinion on Serbia.

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, also the potential candidate countries are assessed according to the same format and methodology.

Difference between Progress Report and Opinion

The 2011 Progress Reports focus on developments during the period October 2010 - September 2011 and seek to assess progress on the two Copenhagen criteria: (1) existence of a functioning market economy and (2) capacity to cope with competitive pressure in the EU. The assessment in the Opinion

¹ Under UNSCR 1244/1999

for Serbia is broader in scope as compared to the progress reports, as it contains 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:

- 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;
- 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;
- 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 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;
- 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.

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 becomes then 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 opinion for Serbia provides 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 2011 Progress Reports and the Opinion (Serbia)

1. CROATIA

In examining 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 2011-2013, submitted in January 2011, presented a sufficiently comprehensive and consistent macroeconomic and fiscal framework for economic policies. Progress was achieved in some of the main areas of the 'Economic Recovery Programme', a package of fiscal measures and comprehensive structural reforms launched in April 2010. 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 caused a protracted recession in Croatia which continued through the first quarter of 2011. In 2010 as a whole, real GDP declined by 1.2% after a 6.0% contraction in 2009. GDP per capita in purchasing power terms fell from 65% of the EU-27 average in 2009 to 61% in 2010. Investment continued to fall at a double-digit rate (-11.3%) while the decline in private consumption diminished markedly (by -0.9% compared with -8.5%). Public consumption also declined (-0.8%) in contrast to a small increase in 2009 (0.2%). In the context of the economic recovery in the EU and in other export markets, export volumes increased by 6.0% in 2010 following the sharp contraction in the preceding year (-17.3%). The decline in import volumes, however, continued, albeit at a much slower speed (-1.3% in 2010 against -20.4% in 2009). The contribution by net exports to real GDP growth remained at 3.0%. The mild decline in economic activity continued throughout the winter of 2010/11 and output was 0.8% lower, year on year, in the first quarter of 2011. Available data indicate a slight upturn of economic activity in the second quarter. GDP was 0.8% higher year on year according to the preliminary estimate. Industrial production started to trend upward and its volume level was 0.9% higher year on year in July. Retail sales have increased consistently on a year-on-year basis since April and were 0.9% higher in July. Exports of goods were 6.3% higher in nominal terms in April-July compared to the corresponding period in 2010. Physical indicators of tourism have increased significantly in the first seven months of 2011 compared to the previous year. Overall, economic recovery had not yet taken hold in early spring 2011, but there are indications that economic activity has started to increase since April.

The government launched the Economic Recovery Programme in April 2010, when the economy was not yet recovering from the recession and fiscal trends were more unfavourable than expected. Apart from some fiscal measures which were quickly adopted, the programme is a package of structural reforms seeking to address the structural weaknesses of the economy and 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 fees, 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. Progress has been made on implementing the planned structural reforms in some of the main areas like pension laws, unemployment benefits, civil service employment and non-tax fees. But fundamental structural reforms have not been achieved so far.

Overall, the measures which have been taken under the Economic Recovery Programme so far have not contributed decisively to improving the growth potential and international competitiveness of the economy.

The current account deficit narrowed to 1.2% of GDP in 2010 from 5.3% in 2009 continuing a cyclical trend which started with the onset of the recession. As in the preceding year, it was again driven by an improving balance of trade in goods. Imports of goods and services declined, but at a much slower rate than in 2009. At the same time, the trade balance benefited from a turnaround to growth in exports, as the recovery took hold in major foreign markets. As a consequence, the trade deficit in goods fell from 16.2% of GDP in 2009 to 12.9% in 2010. The trade surplus for services (mainly tourism and transport) increased slightly from 12.6% of GDP in 2009 to 12.8% in 2010. The deficit on income and transfer payments fell from 1.7% of GDP in 2009 to 1.2% in 2010. The improvement in the current account was sustained in the first quarter of 2011 as continued subdued domestic demand prevented imports from rising more markedly. Overall, the current account deficit has been narrowing, mainly as a result of subdued demand for imported goods, but also thanks to rising exports.

Table 1.1:
Croatia - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	4.9	5.1	2.2	-6.0	-1.2	0.0
Private consumption	Ann. % ch	3.2	6.3	0.8	-8.5	-0.9	0.3
Gross fixed capital formation	Ann. % ch	11.1	7.1	8.2	-11.8	-11.3	-7.0
Unemployment	%	N.A.	9.6	8.4	9.1	11.8	13.9
Employment	Ann. % ch	N.A.	1.8	1.3	-1.9	-4.0	-4.6
Wages	Ann. % ch	6.2	6.2	7.1	2.2	-0.4	1.2
Current account balance	% of GDP	-6.7	-7.3	-8.9	-5.3	-1.2	-1.2
Direct investment (FDI, net)	% of GDP	6.4	8.0	6.7	2.6	0.7	0.2
CPI	Ann. % ch	3.2	2.9	6.1	2.4	1.0	2.3
Interest rate (3 months)	% p.a.	4.46	5.66	7.19	8.96	2.44	2.15
Stock markets	Index	2,771	4,673	3,299	1,871	1,990	2,262
Exchange rate HRK/EUR	Value	7.30	7.33	7.22	7.34	7.29	7.40
Nominal eff. exchange rate	Index	98.7	98.0	96.1	97.2	98.2	99.7
General government balance	% of GDP	-3.0	-2.5	-1.4	-4.1	-4.9	N.A.
General government debt	% of GDP	35.5	32.9	28.9	35.2	41.2	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Net capital inflows receded in 2010 as a corollary of the declining current account deficit. Excluding changes in international reserves, they fell from 9.6% of GDP in 2009 to 3.3% in 2009. More than half of this decline is accounted for by a sharp fall in inward foreign direct investment (FDI). FDI fell to 0.9% of GDP in 2010 from 4.6% in 2009. After net FDI flows had financed only half of the current account deficit in 2009, they covered close to 100% of the much smaller deficit in 2010 despite dropping sharply. The total stock of FDI in Croatia stood at €24.5 billion (around 53% of GDP) at the end of 2010, about 1 percentage point higher than at the end of 2009. Overall, in the context of a declining current account deficit, sufficient external financing was secured by net FDI inflows.

The heavy external debt burden continued to increase in 2010. The stock of gross external debt went up by €1.2 billion to €46.5 billion, which amounts to 102.6% of GDP. The general government increased its foreign debt by around €0.8 billion in the course of 2010 to €6 billion which is equivalent to about 13% of Croatia's gross external debt. 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.

On the labour market the average annual unemployment rate increased from 9.1% in 2009 to 11.8% in 2010 according to the labour force survey. The rising trend of unemployment continued into 2011. In

the first quarter the unemployment rate rose to 14.3% which is 3.1 percentage points higher, year on year. The registered unemployment rate was 0.4 percentage points higher in July 2011 than a year earlier, but this year-on-year increase has declined from 2% last winter. Annual average employment was 4.0% lower in 2010 after a 1.8% decline in 2009. 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. In 2010 the employment and participation rates declined to 54.1% and 61.5% respectively, while youth unemployment surged to 34.4% from 25.1% in 2009. The effective retirement age remained low as there are transitional arrangements on equalising pensionable age. Significant labour supply disincentives persisted. Employment has been negatively affected by Croatia's limited progress on effectively implementing the objective of the Economic Recovery Programme to make the labour market more dynamic and by the lack of incentives structures and the combination of flexibility and security on the labour market. As a result, labour turnover remained low, suggesting limited reallocation of labour resources. Wage movements reflected the weakening of the labour market to some extent. Average gross wages increased by 1.1% year on year in the first half of 2011 in nominal terms and were 1.2% lower in real terms. Overall, the labour market situation continued to deteriorate. Major structural weaknesses persist in the labour market.

Monetary policy continued to be directed 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. In spite of a slight downward trend of the kuna against the euro, monetary policy was able to maintain an accommodating stance in persisting recessionary conditions. As an additional incentive to bank lending, the central bank released €850 million worth of additional euro liquidity into the banking system in early March 2011 by lowering the minimum reserve requirement on banks' foreign exchange liabilities from 20% to 17%. In the foreign exchange market the kuna depreciated 2.9% against the euro between the beginning of October 2010 and mid-September 2011, viz. from 7.30 to 7.52 kuna per euro. The central bank intervened on four occasions to counter depreciation pressures, twice in November 2010, once in July 2011 and once in September 2011, selling a total of €770 million. Nevertheless, overall foreign exchange operations increased gross international reserves from €1,154 million at the end of September 2010 to €1,233 million at the end of July 2011 which is equivalent to around seven months of imports of goods and services. Overall, the central bank maintained an accommodating monetary policy stance in the context of subdued economic activity, while maintaining exchange rate and financial stability.

Following a slight contraction in 2009 domestic credit to the private sector increased by 6.9% in 2010 (or 3.6% excluding exchange rate effects primarily arising from the sharp appreciation of the Swiss franc). This credit expansion was roughly maintained in the first five months of 2011 with an annualised increase of 6.6%. It was exclusively driven by bank lending to the corporate sector which expanded by 9.6% in the course of 2010 and accelerated to an annualised rate of 11.8% in the first five months of 2011. By contrast, lending to private households (adjusted for exchange rate effects) fell by 1.4% in 2010 and this decline continued into 2011. Bank credit to general government increased by 13.8% in the course of 2010 and accelerated to 27.0% in the first five months of 2011. The government's programme to stimulate corporate financing via the State Development Bank (HBOR) had only a limited impact on bank lending. Overall, credit to private households has contracted slightly, lending to the corporate sector has recovered moderately, and the structure of credit has continued shifting towards government financing.

Average annual inflation fell from 2.4% in 2009 to 1.1% in 2010, continuing the trend from the preceding year. The disinflationary process was driven primarily by the growing slack in use of resources transmitted to price- and wage-setting. Since late 2010, however, disinflation has been replaced by a mild upturn in inflation. Higher energy and food prices pushed up headline inflation from 1.2% in November to 2.0% in August. Higher commodity prices have spilled over into areas like

transport and, particularly, processed food. Consequently, the central bank's measure of core inflation increased from -0.2% year on year last November to 1.8% in May. Overall, the recession-induced decline in inflation has been followed by a mild upturn stemming mainly from rising commodity prices.

Public finances worsened again in 2010 mainly as a consequence of the continuing recession. A budget revision in August 2010 lowered projected general government revenue by 4.5% of GDP and increased expenditure by 0.3% of GDP compared with the original budget. The projection for the general government deficit in 2010 was raised by 1.9 percentage points to 5.2% of GDP compared with a deficit of 4.1% of GDP in 2009. The preliminary outturn shows a lower than planned deficit of 4.9% of GDP. This has only been made possible by keeping public investment expenditure some 0.5 percentage points of GDP below budget appropriations. The stock of general government consolidated gross debt increased significantly from 35.2% of GDP at the end of 2009 to 41.2% at the end of 2010. Adding outstanding State guarantees and the debt of the State Development Bank (HBOR), the level of public debt totalled 57.1% of GDP at the end of 2010. The 2011 budget is based on the assumption of 1.5% real GDP growth and 2.1% inflation in 2011. Revenue is projected to decline by 0.8% in nominal terms compared with 2010. This is primarily a consequence of the phased repeal of the special crisis tax on salaries, pensions and other receivables which had been imposed in mid-2009. Another reason is last year's change in income tax rates and tax brackets which lowered annual revenue by an estimated 0.3% of GDP. Expenditure is budgeted to stay at the same level in nominal terms in accordance with a decision adopted by parliament in August 2010. The overall deficit is projected at 5.5% of GDP. According to the Ministry of Finance, the deficit equalled 2.6% of annual GDP in the first six months of 2011. In an ad hoc response to rising oil prices, the government reduced excise taxes on petrol and diesel fuel in March 2011, which will lower revenue by close to 0.1% of GDP on an annual basis. The contraction in output in the first quarter implies a risk of lower-than-projected economic growth and tax revenue and, therefore, a higher-than-projected deficit in the 2011 budget. Overall, the authorities made efforts on the expenditure side of the budget to contain the continuing rise of the fiscal deficit. Ensuring medium-term fiscal sustainability remains a key challenge.

Limited progress has been made on rationalisation of public spending. Some further health reforms have been adopted as a major step towards addressing the sector's financial difficulties. These include streamlining of the administration of the hospital network and of the supplementary health insurance system. Some cuts to privileged pensions have been adopted, but in general little progress has been made towards better targeting of social support in spite of the action announced in the Economic Recovery Programme. Overall, little progress has been made towards increasing the efficiency of public spending.

Strategy-based budget planning has improved with the adoption of a Fiscal Responsibility Law on 23 November 2010. This law, which came into force on 1 January 2011, aims to ensure medium- and long-term sustainability, transparency and discipline for public finances and applies to all general government bodies. It contains fiscal rules aiming to stabilise and reduce the ratio of public debt to GDP. They stipulate that total general government expenditure will be reduced by a minimum of 1% of GDP annually. Once the primary fiscal balance has been brought back to zero, it has to be kept in balance (or in surplus) in cyclically-adjusted terms. The fiscal rules have to be applied for the first time in the public budgets for 2012. The law also contains general provisions on financial control, including presentation of annual statements of fiscal accountability. Responsibility for enforcement of the law lies mainly with the Ministry of Finance, but in March 2011 the government established a Fiscal Policy Committee, consisting of non-governmental experts, to monitor implementation of the fiscal rules. Overall, the Fiscal Responsibility Law has improved strategy-based budget planning and can be used as an instrument to rein in the high budget deficit.

Implementation of a comprehensive treasury reform strategy has continued with a view to further improving expenditure management and budget control systems. In February 2011 the government adopted the Public Debt Management Strategy for 2011-2013. Its objectives are to stabilise the share of public debt to GDP, to extend the repayment period (currently averaging around five years), to introduce a currency risk protection clause especially for debt denominated in US dollars, to develop the domestic securities markets and to achieve a balanced distribution of public debt between foreign and domestic markets. 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. More progress is required to bring fiscal reporting closer into line with ESA95 standards. Further progress is also required on linking policy priorities to the budget planning process more effectively. Overall, analytical and institutional capacity on public finance has continued to improve, but strategy-based budget planning could be strengthened further.

Overall, the macroeconomic policy stance has, by and large, been appropriate to address the macroeconomic challenges given the existing constraints. Monetary policy maintained exchange rate and financial stability while remaining appropriately accommodating in a context of subdued economic activity. Fiscal policy has, to some extent, contained the negative budgetary consequences of the continuing recession. To achieve medium-term fiscal sustainability, key challenges remaining are to improve the budgetary process further, to strengthen fiscal discipline and to enhance the efficiency of public spending.

Interplay of market forces

The private sector's share of employment has remained at around 70% and its share of GDP is also estimated at around 70%. Only limited progress was made with privatisation of publicly-held assets. In the period between 15 September 2010 and 30 June 2011 a total of 83 companies were privatised, including through bankruptcy and winding-up procedures. The proceeds of the sales were relatively modest (about €11 million) since many of the companies were liquidated in the process. The remaining portfolio comprises 693 companies, with the State holding majority ownership in 92 of them. The portfolio's nominal value was set at around €7.7 billion at the end of June 2011, up by about 3% since mid-September 2010. Since the remaining holdings consist predominantly of highly indebted and often loss-making companies, finding strategic partners is a lengthy process, requiring several stages prior to declaring bankruptcy or liquidation. As regards the shipbuilding sector, which generates revenue equivalent to about 2.5% of GDP, restructuring and privatisation continued. In December 2010 parliament adopted a Law on State property management which created the Government Asset Management Agency by merging the Croatian Privatisation Fund with the Central Administrative Office for State Property Management. This consolidation should allow better management of all State property and easier access to State property for potential investors by allowing new sales models. Overall, very limited progress has been made towards reducing the large role of the State in the economy.

Market entry and exit

The legal framework for companies entering and leaving the market was improved by the adoption of a number of laws (on forfeiture, litigation procedures, bankruptcy and court registering). Preliminary data indicate that the number of newly registered companies declined by 8.6% in 2010, year on year, and the total number of registered businesses declined by 1.9%. A bill on regulatory impact assessment has been enacted by parliament in July 2011. A regulatory impact assessment strategy has been drafted and three pilot projects are under way. The investment climate still suffers from difficulties in obtaining the necessary licences, building permits and other authorisations, as well as from the unpredictability of administrative decisions, in particular at local level. A large number of non-tax fees at national and local levels still burden entrepreneurs although they have been reduced, on average, by about 25% as part of the Economic Recovery Programme. Overall, further progress has

been made on simplifying company registration, but the investment climate continues to suffer from a heavy regulatory burden, unpredictability of administrative decisions and numerous non-tax fees.

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 is still affecting the business environment, which 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, the judicial system has been improved, although enforcement of property rights is still weak. Improving the business environment should remain a priority in the accession process.

Financial sector development

The financial sector continued to be dominated by banks, which held 75.3% of the total assets of financial intermediaries at the end of 2010. The foreign-owned banks had a market share (i.e. share of total banking assets) of 90.5%. The banking sector is almost completely privatised with only two out of 32 banks remaining State-owned, together holding a combined market share of 4.2%. There were 23 small banks with market shares below 1%, three medium-sized banks with a share of between 1 and 5% and six large banks with market shares above 5%. The market share of the four largest banks remained practically unchanged and added up to 65.6% at the end of 2010. Market concentration has remained moderate and has generally not hindered market competition.

Banking sector assets increased by 5.2% in 2010 compared with only 2.7% in 2009. About half of the rise was due to increased lending to the private corporate sector and about one third stemmed from increased lending to the government sector. The rise in household lending was due solely to the rising value of the Swiss franc which increased the size of residential loans to the household sector. In terms of GDP, total bank lending rose from 75.8% at the end of 2009 to 81.3% at the end of 2010. 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 remained high at 18.4% at the end of 2010, only slightly down from 19.2% in mid-2010. Subsequently it has climbed back up to 19.1% at the end of March 2011. The profitability of banks recovered somewhat in 2010 after the deterioration in the previous year. The return on average equity increased to 7.0% after having declined from 9.9% in 2008 to 6.4% in 2009. High provisioning costs continued to weigh on banks' profits. The share of non-performing loans continued to increase rapidly in 2010 reaching 11.2% at the end of the year, up from 7.8% at the end of 2009. In the course of the first quarter of 2011 it increased further to 11.5%. The main driving force behind this rise was the deteriorating quality of household loans against the background of deteriorating labour market conditions and the Swiss franc's appreciation against the kuna¹. Developments affecting the stability of the financial sector have been kept under close watch by the central bank, which built up 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 unhedged liabilities of the non-financial private sector.

¹ The Swiss franc appreciated 13.4% against the kuna between 1 October 2010 and 19 September 2011. It represented 16% of all foreign-currency-indexed or –denominated bank loans in the first quarter of 2011 (and 12% of all bank lending).

The share of non-banking financial sector assets in total financial sector assets remained largely unchanged in 2010 on 23.3% at the end of the year. The stock market index rose by 5.3% over the year 2010, following a gain of 16% in 2009, but was still about 60% below the peak in 2007. Market capitalisation of shares listed on the Zagreb stock exchange increased from 40.9% at the end of 2009 to 42.1% at the end of 2010. Market capitalisation of all listed bonds rose from 11.0% of GDP at the end of 2009 to 15.8% in the course of 2010, mainly due to the new domestic bonds issued by the Croatian government. 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 heavy 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

Croatia is a functioning market economy. The macro-economic policy stance to cope with the continuing recession has, by and large, been appropriate given the constraints on both fiscal and monetary policy. Prudent measures 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.

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. The process of referencing the Croatian Qualifications Framework to the European Qualification Framework is ongoing. 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. 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 Economic Recovery Programme and 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. Structural problems persisted on the labour market, as indicated by the high youth unemployment and low employment and participation rates. Overall, structural weaknesses in the labour market remain major challenges.

Investment continued to fall sharply in 2010, mainly due to a drop in construction activity. As a share of GDP, investment fell from 24.9% in 2009 to 21.6% in 2010. The decline in investment in processing and manufacturing industry has harmed the prospects for faster technological change, a more diversified production structure and higher export potential. Public investment slowed down a little, but remained significant, in particular in the motorway network. The largest share of cumulative FDI inflows (over the period 2003-2010) is accounted for by the financial sector (37%), followed by manufacturing (21%) and wholesale and retail trade (17%). The long-standing shortage of greenfield FDI continues. In October 2010 the government put forward a catalogue of 30 public-sector investment projects worth €13.85 billion. The projects should be carried out by public companies and local authorities in the areas of energy, tourism, water management and transport infrastructure. It remains unclear when work on these projects will begin, since the government has secured only a small amount of the financing needed. 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 priority in the accession process. The privatisation of the yards is in its final stage. One shipyard out of five reimbursed the State aid received since March 2006 and is no longer considered a shipyard in difficulty under State aid rules. Implementation of the National Restructuring Programme (NRP) for the steel sector was disrupted by the global economic crisis and is no longer needed. One of the steel mills is currently subject to a bankruptcy procedure. The private investor in the other steel mill has decided to reimburse the aid. There has been only limited progress on restructuring the State-owned railway company (staff reductions) and privatising its subsidiaries. The railways continue to receive high levels of budget support. Overall, although privatisation of the shipyards has proceeded, further efforts are now required to complete the process. Sustained efforts are required to complete the restructuring of the railways to secure their long-term viability and competitiveness.

The telecommunications industry was further liberalised. The Croatian Telecommunications Agency continued activities with the aim of stimulating competition by improving market access for 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 rules for the gas transport and distribution network 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 dominant services sector increased its share of total gross value added from 68.2% in 2009 to 68.8% in 2010. The share of industry rose from 18.4% to 19.0% and the share of agriculture, forestry and fishing from 5.4% to 5.5%. These gains were made at the expense of construction whose share of total gross value added declined from 8.0% in 2009 to 6.7% in 2010. The share of construction in total employment decreased from 8.8% in 2009 to 7.5% in 2010 and the share of industry from 19.5% to 19.0%, whereas agriculture's share increased from 13.9% to 14.9%.

In the first three quarters of 2010, small and medium-sized enterprises (SMEs) accounted for 67.2% of total employment and 52.2% of total investment. SMEs generated 51% of gross profit and more than 45% of total exports. Except for gross profits, where their share declined, all their indicators improved compared with the previous year. The State Development Bank (HBOR) was further strengthened financially to enable it to increase lending to SMEs on more favourable terms. Still, the sector continued to suffer from the cumbersome regulatory framework and inefficiencies in public administration. Access to longer-term financing remained difficult, particularly for newly established businesses. Overall, the government continued to support the SME sector, whose relative share in the overall economy increased.

State influence on competitiveness

The Competition Agency has been given a stronger role in the antitrust and mergers field. Administrative capacity and enforcement of competition policy continued to improve. Public subsidies remained unchanged at the high level of 2.4% of GDP in 2010 and a large share still went to loss-making companies. Horizontal aid continued to account for only a small share of total subsidies, although it increased relative to sector-specific aid. 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 77% of GDP in 2010. Although this ratio is 2 percentage points higher than in 2009, it is still significantly below

the level of 92% in 2008. Apart from exports of machinery and transport equipment (mainly ships), tourism remained the biggest source of export revenue, generating an unchanged 14% of GDP in 2010. The EU has continued to be Croatia's largest trading partner. Its shares of total Croatian exports and imports remained relatively stable in 2010 at 61% and 60% respectively. CEFTA countries accounted for 10.3% of all Croatian trade in 2010, slightly below their share in 2009. 94% of all FDI stocks stemmed from EU Member States. Overall, integration with the EU in the areas of trade and investment remained high.

The average real effective exchange rate deflated by consumer prices fell by 1.4%, year on year, in 2010, mainly due to the nominal depreciation of the kuna against a basket of currencies of major trading partners and partly to a smaller increase in domestic than in foreign consumer prices. However, the average real effective exchange rate deflated by producer prices increased slightly year on year (0.2%), despite the nominal effective depreciation. Using unit labour costs as the deflator, the kuna depreciated by 4.9% year on year in real effective terms in the first three quarters of 2010. Unit labour costs decreased due to the stronger fall in employment than in GDP and falling compensation per employee. Overall, standard indicators point, on balance, to some improvement in Croatia's international price competitiveness in 2010.

1.3. Conclusions

The economy of Croatia was still in recession in 2010 and the first quarter of 2011 in spite of the recovery in the economies of the EU and other trading partners. There are, however, signs of increasing economic activity since the spring. Unemployment, public deficit and debt continued to increase. The high external indebtedness remains a key vulnerability of the economy.

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. Given the existing constraints, macroeconomic policy has, by and large, been appropriate to address the challenges of the recession. The central bank succeeded to preserve exchange rate and financial stability while maintaining an accommodative monetary policy as underlying inflationary pressures stayed low. The banking sector remained resilient to shocks. In the fiscal area, the authorities made efforts to contain the rising deficit by reining in expenditures. The budgetary framework for achieving fiscal sustainability over the medium term has been improved. The current account deficit continued to narrow as exports expanded while subdued domestic demand kept imports low. Some progress, albeit limited, was achieved on structural reforms within the framework of the Economic Recovery Programme.

However, in overall terms the speed of structural reforms remained slow, not least with respect to privatisation and the restructuring of loss-making enterprises. The investment climate continued to suffer from a heavy regulatory burden, unpredictability of administrative decisions in particular at local level and numerous non-tax fees. Planned reforms of the highly rigid labour market were narrowly circumscribed and the already low employment and participation rates declined further. Social transfer payments, which represent a relatively high share of public budgets, remained not well-targeted. Considering the need to achieve medium-term fiscal sustainability, the budgetary process could be improved further. Enhancing the efficiency of public spending remains a key challenge.

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

Economic policy has continued to be oriented towards stabilising the economy from the severe recession that the country experienced following the collapse of the banking sector. Cooperation with the IMF provided an important anchor for economic stabilisation. The authorities managed to deliver key policies laid down in the IMF programme leading to its successful completion in August 2011. The country also managed to re-enter international capital markets with a successful US\$ 1 billion bond issue in mid-2011. Broad political consensus on the key essentials of a market economy and the preservation of the welfare state continues to be strongly embedded in Iceland's society. A three-year collective wage bargaining agreement for the private sector was concluded in the spring, which reduces uncertainty for businesses and consumers, but the ensuing wage increases put additional strain on the economy, in particular the non-tradable sector, and on public finances. The previous political cohesiveness within Iceland remains stretched by the negative effects of the crisis. The country was included in the EU's multilateral pre-accession fiscal surveillance procedure and submitted its first Pre-Accession Economic Programme (PEP) in January 2011. It sets out an ambitious medium-term fiscal framework which, however, is based on a somewhat optimistic macroeconomic scenario and not fully underpinned by comprehensive supporting structural reform measures.

Macroeconomic stability

Following the collapse of its financial sector in October 2008, the Icelandic economy went into a deep and long recession. Real GDP continued to fall in 2010, by 4%, which was larger than expected decline, following a 6.8% drop in 2009. The recession bottomed out in the second half of 2010, when the economy started to recover mildly, based on stronger private consumption and a stronger export performance by non-aluminium and non-maritime products. In the first half of 2011, the recovery continued with a real GDP increase of 2.5% backed by consumption and investment growth, whereas real exports declined. However, the recovery is tentative. Annual growth decelerated in the second quarter compared to the first quarter. Moreover, stronger consumption growth has been largely driven by transitory measures, such as one-off pay increases, pension withdrawals, temporary subsidies and transfers, and debt relief measures provided to households. Balance sheet vulnerabilities remain in both the corporate and household sectors and continue to impede a stronger resumption of growth. As a result of the crisis, average per capita income (in Purchasing Power Standards) fell to 110% of the EU-27 average in 2010, from 117% a year before. Overall, the economy continued to recover, however, at an uneven and moderate pace, and risks and uncertainties persist with respect to the sustainability of growth.

External deficits have shrunk markedly following the recession. The sharp contraction in domestic demand and depreciation of the exchange rate (around 50% in 2008/09) contributed to a further improvement in the balance of goods and services, which recorded a surplus of 10% of GDP in 2010, after 8.4% in 2009. The current account deficit in 2010 stood at 11.2% of GDP, down from 11.7% in 2009, reflecting mainly the improvements in trade in goods and services. However, the reported current account balance remains heavily influenced by accrued interest of banks in winding-up proceedings which do not reflect any current (or future) outflow of funds. Corrected for these factors, the current account recorded a much lower deficit of 2.4% of GDP in 2010, according to the Central Bank's estimates. In the first half of 2011, the annualised current account slightly widened to 11.6% as

a lower merchandise trade surplus was only partly compensated for by a stronger services and net factor income balance. Merchandise trade data for July and August point to stronger export growth of around 25 and 33% year-on-year, respectively. However, cumulative export growth in 2011 has been weaker than the growth of imports, reversing the trend seen in 2010 which supported a strengthening of the current account. Overall, the current account deficit fell in 2010, but developments in 2011 so far point to a smaller trade surplus as compared to the previous year.

Table 2.1:
Iceland - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	4.7	6.0	1.3	-6.7	-4.0	2.5
Private consumption	Ann. % ch	3.6	5.7	-7.9	-14.9	-0.4	3.1
Gross fixed capital formation	Ann. % ch	24.4	-12.2	-20.0	-51.1	-8.0	2.3
Unemployment	%	2.9	2.3	3.0	7.2	7.5	8.5
Employment	Ann. % ch	5.1	4.5	0.7	-6.1	-0.3	-0.4
Wages	Ann. % ch	9.5	9.0	8.1	3.9	4.8	5.0
Current account balance	% of GDP	-23.8	-15.7	-24.5	-11.7	-11.2	-11.6
Direct investment (FDI, net)	% of GDP	-10.2	-16.5	30.4	-18.2	23.7	24.2
CPI, average	Ann. % ch	6.7	5.1	12.7	12.0	5.4	2.8
Interest rate (3 months)	% p.a.	12.35	14.28	15.84	11.28	6.79	4.02
Stock markets	Index	5,494	7,017	3,510	465	563	616
Exchange rate ISK/EUR	Value	87.84	87.66	127.58	172.15	161.62	161.36
Nominal eff. exchange rate	Index	89.5	90.9	65.9	47.6	48.7	48.9
General government balance	% of GDP	6.3	5.4	-13.5	-9.9	-10.1	-5.2
General government debt	% of GDP	30.1	28.6	70.4	106.6	124.3	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Total net capital inflows in 2010 and in the first half of 2011 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 20% of GDP in the twelve months to July, reaching 57% of GDP. The increase in reserves partly reflects official financing provided in the context of the IMF programme and through bilateral loans as well as foreign exchange interventions to bolster non-borrowed reserves. A very high level of external debt continues to pose a key challenge to the Icelandic economy. Official debt statistics report the stock of gross foreign debt at 867% of GDP (end-2010). However, corrected for foreign debt of banks and holding companies in winding up proceedings and of one single international company (the pharmaceutical company Actavis) headquartered in Iceland but with most of its operations abroad, Iceland's total external debt appears to be considerably lower. The Central Bank estimates the 'corrected' external debt stock at around 200% of GDP and Iceland's net international investment position at a negative 23% of GDP. This compares favourably with a pre-crisis external debt of around 570% of GDP. Overall, foreign exchange reserves strengthened, partly backed by official external financing, and recent estimates of Iceland's net international investment position suggest a much lower external indebtedness compared to the pre-crisis period.

The labour market remains weak with unemployment close to historically high levels at 7.5% in 2010 and the number of employed significantly lower compared to pre-crisis levels. These crisis-related effects continued to be felt in the first half of 2011 as unemployment reached 8.5% in the second quarter of 2011, only slightly lower than in the same period of 2010. The level of total employment fell by 1% year-on-year in the first quarter and rose marginally in the second quarter (0.3%). Data on registered unemployment point to a fall in the average unemployment rate in the first eight months of 2011, to 7.7% as compared to 8.4% in the same period a year before. Elements of labour market flexibility seem to have provided a degree of cushion, such as a reduction in the number of hours worked (which remain 6.5% below pre-crisis levels), increased part-time work net migration and labour market measures prevented an even larger increase in unemployment. At the same time, weak labour market conditions continued to have a serious effect on long-term unemployment which increased to around 25% of total unemployment in the second quarter of 2011, around 8 percentage

points higher than the same period a year ago. Also, the youth unemployment rate as a share of total unemployment remained high at nearly 19%. Despite high unemployment, the annual average growth of gross wages continued to accelerate in 2011 to 7.1% in June. Thus, average wage growth in the first half of 2011 reached 5%, compared to around 4% in the first half of 2010. The disinflation process has pushed real wage growth into positive territory since the second half of 2010, leading to average real wage increases of around 2% in the first half of 2011, but the recent rise in inflation will lead to a decline in average real wages. Overall, the labour market remains seriously affected by the deep post-crisis recession with high unemployment rates, particularly among the youth and long-term unemployed.

The monetary policy easing implemented since March 2009 came to an end in late 2010 when policy rates had reached historically low levels (4% compared to the peak of 18% in March 2009) and the policy focus moved increasingly towards the preparation for a gradual lifting of capital controls. In August 2011, policy rates were raised for the first time since March 2009, by 0.25 percentage points to 4.25%, in reaction to rising inflationary pressures. After annual inflation had fallen below the Central Bank's official 2.5% inflation target in early 2011, inflation accelerated markedly to 5% in July and August as a result of a weaker exchange rate, rising oil-, house- and food prices and strong pass-through effects from unexpectedly high wage increases negotiated in the collective wage agreements of May. These factors have worsened the inflation outlook, and inflation expectations have risen markedly. Overall, monetary policy has been tightened slightly as a result of a significantly worsened inflation outlook.

The Central Bank has followed and intends to continue a strategy of exchange rate stabilisation supported for the time being by a system of capital controls. The underlying trade surplus, improved terms of trade, and the declining risk premium have supported a strengthening the Icelandic króna by over 16% vis-à-vis the euro in 2010. However, in early 2011 the króna started to weaken, partly due to large purchases of foreign exchange by the Central Bank at end 2010. In the first half of 2011, the króna lost some 8.3% of its value vis-à-vis the euro, but again slightly appreciated since then. The Central Bank continued to abstain from intervening in the foreign exchange market to support the króna since December 2009 but it purchased foreign exchange through auctions to bolster non-borrowed reserves. Under the current policy framework, while exchange rate risks appear limited over the short term, they could become more prominent in view of the need to gradually liberalise capital movements.

The first step towards lifting capital controls was taken in October 2009 when restrictions on inflows of new capital were abolished. A revised strategy for lifting capital controls was approved by the government in March 2011 following a proposal from the Central Bank. The revised strategy was devised in consultation with the IMF. In a first step, it focuses mainly on reducing the risk of outflows from large holdings of króna by non-residents. These holdings are estimated at around 30% of GDP. The second step of the strategy foresees a liberalisation of on-shore króna holdings. First steps of the revised strategy were taken in mid-2011, whereby the Central Bank bought foreign króna holdings in two auctions to re-sell them to domestic pension funds. While the first auction was entirely successful, pension funds proved to be reluctant to purchase króna holdings in the second auction, probably as a result of increased risk aversion in international capital markets. The authorities aim to lift the controls gradually as conditions permit; nevertheless, this could still entail potential risks.

Following a marked deterioration of public finances in the wake of the crisis, the authorities took a series of fiscal consolidation measures to reduce the fiscal deficit by around 3 percentage points in 2010, from 10% of GDP in 2009. While the measures were successful in reining in spending and strengthening the revenues, the revised general government deficit in 2010 remained at virtually the same level as in 2009, as measured in % of GDP, as the overall budget spending was affected by called guarantees for the Housing Financing Fund and the Agricultural Fund. The 2011 budget framework adopted in late 2010 initially foresaw new fiscal measures amounting to around 2.7% of

GDP with most of the adjustment on the expenditure side (2% of GDP). This was a change to the structure of fiscal adjustment in 2009 and 2010 which was largely based on revenue measures. The first half of the year showed strong revenue performance and spending below projections. Total general government revenues increased by 3.9% and total spending by 0.9% year-on-year. The general government balance recorded a deficit of 2.5% of (annual) GDP, compared to a deficit of 3.1% in the first half of 2010. However, in the context of the three-year collective wage agreement adopted in Spring, the government took additional spending commitments, comprising additional public investment as well as social protection, active labour market policy and education measures. As a result, expenditure measures in 2011 are expected to account for 1% of GDP instead of 2% as initially foreseen. Moreover, the government decided to moderate the medium-term fiscal adjustment path by postponing the achievement of a sizeable fiscal surplus by one year from 2013 to 2014. Fiscal risks remain significant as growth could turn out to be lower than expected. Risks could also arise also from contingent liabilities related to government guarantees for public companies and a possible further need to recapitalise the State Housing Financing Fund, which suffers from uncertain asset quality and low capital ratios. Finally, litigation risks are related to the still unsettled Icesave-dispute and the Supreme Court's ruling on the Emergency Law. A decision overturning the Law would have significant implications for Iceland's public finances. Overall, expenditure-based fiscal consolidation remains challenging and possible risks arise from contingent liabilities.

Gross general government debt increased from 88% of GDP in 2009 to 93% at end-2010 and debt levels remain high compared to pre-crisis levels of around 30%. Further progress has been made in establishing a medium-term public debt management framework. A medium-term debt management strategy was published in February 2011 and the positive reception by market participants bodes well for the implementation of the 2011 annual borrowing plan which foresees accessing international markets in the course of the year. In June, Iceland issued international bonds in the amount of US \$1 billion with a 5-year maturity at an interest rate of 4.99%. This was the first international issue after the onset of the crisis two and a half years ago. The transaction was well-received by global investors and the amount was two times oversubscribed. The average maturity profile of the public debt portfolio has been extended to over 4 years, including through debt buy-back operations. Finally, a comprehensive legislation to strengthen local government fiscal frameworks and finances has been submitted to Parliament. It foresees strict limits on municipal borrowing, a rolling three-year balanced budget and the introduction of a new data-based and more effective monitoring system. The new framework is set to become fully operational in budget year 2012. Overall, in view of the high level of public debt, the authorities have taken further measures to reduce refinancing risks and to strengthen local government finances.

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, but the recent fiscal easing and a worsened inflation outlook require a continuation of a tight policy mix. In this respect, the 2012 budget and medium-term fiscal plans will be a test for the government's commitment to continued fiscal adjustment. Finally, macroeconomic stabilisation occurred in a situation of temporary protection through capital account restrictions. Looking forward, their gradual 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 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 transferred to their foreign creditors as a compensation for net domestic assets transferred to the new banks. 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 government has also become a large investor in the

remaining savings banks system. The system has, however, been reduced substantially with the exit of the two largest savings banks. The government's stake in the financial firms is held at arm's length from the political process via a special agency.

The private sector accounts for around 75% 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, but public ownership remains significant in some sectors, partly as a result of the crisis.

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 entry exist in the fishing, agriculture and energy sectors, which are not covered by the EEA. Icelandic legislation contains prohibitions on foreign ownership in the fisheries, energy, air transport and real estate sectors. Of these, restrictions on investment in fisheries are the only ones that apply to EEA nationals. The recession has significantly affected company start-ups. Despite some pick-up in March, the number of newly registered private limited companies declined by 6.5% year-on-year in the first half of 2011 and remained at around 60% of pre-crisis levels. Bankruptcy proceedings are generally straightforward. However, the financial crisis has put a large part of the corporate sector under severe financial distress. Actions have been taken to address this problem, including expediting out-of court procedures and by increasing the number of judges and their assistants. The number of insolvent companies increased rapidly by some 50% in the first half of 2011, compared to the same period in 2010. Overall, high barriers to market entry for non-residents remain in key strategic sectors and market exit is complicated by large corporate sector indebtedness.

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 restructuring of the banking sector has been largely completed even though further operational and financial restructuring is required to allow for the resumption of bank lending and the required consolidation in the sector. 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 banking sector credit to the private sector is estimated at 90% of GDP at the end of 2010, somewhat lower than the year before and 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 and financial imbalances are likely to persist for some time. Assets are largely denominated in or indexed to foreign exchange whereas liabilities are in domestic currency and at variable interest rates. Balance sheet imbalances pose a significant challenge to financial sector stability, in spite of banks' currently high capital adequacy ratios, reported well above 12% of tier 1 capital. Private households and businesses are faced with significant operational problems and

nonperforming loans are exceptionally high (at about 40% of total loans). In reaction, the government has put private sector debt restructuring at the forefront of its economic policy. Various programmes, including debt relief programmes for household's mortgages and a voluntary framework for SMEs have gained pace. In addition, the use of the Financial Supervisory Authorities prudential powers is meant to support this process. The banking sector seems sufficiently strong to bear the burden of debt restructuring, as the difference between loan and book value implies a high level of buffers to offset potential losses after restructuring.

On the funding side, banks are currently relying to a large extent on domestic deposits. The banks' exceptional liquidity experienced in early 2010 has been reduced as investors seek higher returns and the lower policy rate has led to falling deposit rates in the banks. The blanket guarantee on deposits remains in place and the government has put before parliament a draft law establishing a new deposit guarantee scheme fully in line with EU regulations and a €100,000 deposit guarantee. At the same time, foreign direct investment and access to foreign credit still remains limited. The operational restructuring of the savings banks has further progressed, but there remains scope for a further consolidation of the sector. Overall, banking sector restructuring has further progressed, but significant vulnerabilities remain with respect to banks' asset quality.

Progress has been made in strengthening bank regulatory and supervisory practices, but supervision needs to be strengthened further to bring it in line with international best practice. A Basel Core Principles Assessment of Effective Bank Supervision was concluded in mid-April 2011. On this basis, the FME has developed a 2-year action plan to address remaining supervisory gaps.

The non-banking financial sector comprises the government-owned Housing Finance Fund, investment banks, leasing companies, payment card companies, investment credit funds and insurance companies. The government injected €206 million into the Housing Financing Fund to raise its capital to about 2% of risk-weighted assets, still far below the 5% pre-crisis level. The government is currently working on a comprehensive review of the Fund's operations and its position within the restored financial system, expected to be completed by end-2011. Leasing companies and payment card companies were fully recapitalised in early 2011 without public support. Total credit provided by the sector fell by 8.5% in the first half of 2011 compared to the same period in 2010 as leasing companies wrote down foreign indexed loans in accordance with the 2010 court rulings and a related law passed in late 2011. The market of both non-life and life insurances expanded through 2010 with total assets increasing by around 6%. Insurance firms also strengthened their equity base. Profits were lower than a year before, partly due asset revaluation needs. Overall, a number of steps have been taken to restore the non-banking financial sector but an overhaul of the Housing Financing Fund's operations remains a challenge in view of reducing the government's contingent liabilities.

Domestic equity markets continue to play a much smaller role in financial intermediation than before the crisis in late 2008. Turnover in the equity market in 2010 remained muted at only 2% of the 2008 pre-crisis turnover. Despite an annual increase of 28%, the total market value of all listed shares remains at only 17% of GDP compared with the pre-crisis level of 120% of GDP (end-March 2011). The bond market, on the other hand, continues to be rather strong even though turnover remains at only 50% of the 2008 level and is dominated by government- and government-guaranteed bonds. Overall, domestic financial markets have somewhat recovered on the back of a more lively bond market while confidence in equity markets remains 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 is slowly recovering levels 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 and despite some progress in private debt restructuring, consumption and investment activity remain markedly restrained, holding back the recovery process. An efficient allocation of resources remains limited in parts of the economy, also due to financial sector weaknesses and capital restrictions. Overall, challenges remain for improving the functioning of markets.

Human and physical capital

The economic crisis severely affected the labour market situation. The labour participation rate has been reduced somewhat to 81.1% in 2010 from the 2007 pre crisis level of 83.3%, but remains nonetheless high in international comparison. The share of people in part-time work has increased (to 27% from 23% prior to the crisis) and total hours worked have been reduced by around two hours to 39 hours a week in 2010. Outward migration may have prevented the unemployment rate from rising even faster, but net migration could be associated with a loss of needed skills, even though the total number halved in 2010 compared to 2009. The structure of unemployment remains problematic with youth and low-skilled workers representing large shares of the unemployed. The rising share of those youths neither in education nor in the labour force has been pronounced. Under these circumstances, efforts to offer re-training and education are essential to reduce skills mismatches. Active labour market initiatives and life-long learning approaches continued to be carried out aimed at retraining and upgrading skills of the labour force. Moreover, the government introduced measures to grant all persons under the age of 25 years access to free secondary education. Total education spending has remained at around 7.8% of GDP in 2010, but is foreseen to drop in 2011. Overall, with unemployment still very high, human capital remains significantly underutilised.

Abundant geothermal sources have attracted substantial foreign investment in the aluminium and hydropower sectors over the past. Even though the financial crisis has slowed down investment, several new projects are now being prepared as access to international capital has been gradually restored – as evidenced by the successful financing by the state power company Landsvirkjun in international financial markets. The share of investment spending in GDP reached only a low 13%, even slightly lower than a year before, and markedly below the 30% pre-crisis share. Investments in all sectors have been affected. At the same time, the fall in real estate activities and construction reflects also some normalisation following the earlier 'boom' years. Public investments have also fallen, from 4% to under 3% of GDP, with the largest declines in transport infrastructure. Net FDI inflows turned again positive in 2010, partly due to new FDI inflows and partly due to residents reducing their outward investments, raising the total stock of inward FDI to around 85% of GDP, up from 72% a year before. With respect to future investment potential, Iceland is implementing a large-scale mapping exercise of its energy resources to categorise them into areas for conservation and those available for exploitation. Overall, the country continues to benefit from good basic infrastructure, abundant natural resources, and an overall well-educated population.

Sector and enterprise structure

Although some new segments in manufacturing and services have expanded over the past years, in particular in high-tech areas such as software production, pharmaceuticals and biotechnology, the economy's industrial sector continues to be characterised by a limited degree of diversification. The relatively small industrial sector (excluding construction), mainly aluminium manufacturing, represents roughly 9% of output and one-fifth of employment. The share of construction in GDP has fallen markedly, from 11% in the boom year of 2007 to 4% in 2010, reflecting adjustments in an over-leveraged sector as well as completion of large energy-related projects. The share of the services 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. The importance of tourism and

transport as a source of foreign exchange income has been increasing, accounting for a quarter of total export earnings in the twelve months to June 2011, also as a result of the 20% yearly increase in foreign tourists in the first half of 2011, which marked a significant turnaround. The importance of small firms in the economy remains high, accounting for 99% of the total number of firms and 70% of employment and output. Overall, the country's industrial sector remains little diversified and the construction sector continues to deleverage.

State influence on competitiveness

The level of state subsidies amounted to 1.8% of GDP in 2010. 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 protected from foreign competition. 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 the results of the ongoing policy debate as regards the domestic allocation of fishing quotas. Energy production remained largely in government ownership, with large consumers being offered relatively favourable electricity prices. Following its intervention in the banking sector the government retains majority ownership in one of the three new banks. The savings banks sector has also been largely restructured with the largest savings bank being merged with a commercial bank. While the government announced it would give creditors a chance to hold most of the equity, the process will most likely involve some additional state support. The Housing Financing Fund remained state-owned and may require additional public funds to bolster its capital base. 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 telecommunications sector is liberalised and privately owned while government interventions remain limited to infrastructure investments in remote areas. Overall, state interference remains significant in some areas including the banking sector.

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 remains little diversified. Marine products and aluminium account for two thirds of merchandise exports. The share of services, mainly travel and transport, remained fairly stable in 2010 at around 25% of total exports, and increased slightly in early 2011. The import structure is 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 nearly 80% in 2010, up from around 75% a year before, and just over half of the country's imports originate in the EU. FDI inflows almost exclusively originate from EU partner countries. Overall, integration with the EU in the areas of trade and investment remained very high.

Rough estimates point to a slight deterioration of average labour productivity in 2010. As a result, unit labour costs are estimated to have increased, as real wage adjustments (a fall by 0.6% in 2010) could only partly compensate for lower productivity. In 2010, the exchange rate of the króna against the euro appreciated by around 16% in nominal and by around 13% in real terms (adjusted for different price developments). According to estimates, the real exchange rate remains around 20% below its long-term average. Overall, despite an appreciation of the real exchange rate in 2010, Iceland still benefits from strong price competitiveness vis-à-vis its main trading partners as a result of the marked depreciation of the króna during the crisis.

2.3. Conclusions

The economy of Iceland is slowly recovering from the fallout of its financial crisis and the deep and long recession that followed, but growth prospects remain weak as households and firms continue to suffer from a high level of indebtedness. Economic policies continued to be oriented towards stabilisation, firmly anchored by the successful completion of an IMF programme. Recently rising inflation prompted the central bank to increase interest rates whereas fiscal policy was somewhat relaxed. Expenditure-led fiscal adjustment to reduce public debt to sustainable levels remains a challenge. Unemployment is high, particularly among youth and long-term unemployed. Despite progress in banking sector restructuring, the economy still suffers from a dysfunctional financial sector and the removal of capital controls represents a key challenge.

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 should be able to cope with competitive pressures and market forces within the Union over the medium term, provided that it continues to address current structural weaknesses through appropriate macroeconomic policies and structural reforms.

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 trade surpluses and an appreciating exchange rate the central bank continued to reduce its policy rate in the second half of 2010, but reacted with a modest tightening of monetary policy as of August 2011 in reaction to a weaker currency and significantly rising annual inflation. Efforts to strengthen public revenues and implement spending cuts have continued. In view of the high level of public debt, measures were taken to reduce refinancing risks and to strengthen local government finances. Foreign exchange reserves continued to increase and recent central bank estimates point to a more manageable external debt position. New measures were taken to accelerate private sector debt restructuring. A revised strategy for capital account liberalisation was adopted and its implementation remains a challenge. The labour market remained flexible and participation rates relatively high. The country enjoys good basic infrastructure, abundant natural resources, and overall a well-educated population.

However, macro-financial risks remain elevated. Domestic demand has picked up, but the recovery is largely based on temporary measures which supported private consumption. Risks and uncertainties with respect to future sources of growth and its sustainability remain. The financial sector is still suffering from weak asset quality and an efficient financial intermediation remains hampered by the incomplete private sector debt restructuring process. Public debt has risen above 90% of GDP. The fiscal consolidation path has been somewhat relaxed and public finances remain confronted with the challenge to implement severe spending cuts to enhance long-term sustainability. Fiscal risks arise from sizeable contingent liabilities and the unresolved Icesave issue. The labour market continues to be seriously affected by the deep post-crisis recession with unemployment unprecedentedly high for the country, particularly among the youth and with the large share of long-term unemployed. Growth, investment and development are hampered by weaknesses in the business environment, such as high barriers to market entry in certain sectors. The industrial structure remained little diversified.

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 regarding the fundamental features of the country's economic policy setup has been maintained. A number of programmes describe the medium-term policy framework. In January 2011, the authorities submitted their fifth Pre-accession Economic Programme, which presented a feasible, albeit sometimes optimistic macroeconomic and fiscal framework and displayed improved drafting capacities. The authorities adopted a public investment programme for 2011-13, a fiscal strategy for 2011-2013 and a public debt strategy for 2011-13. In late 2010, the government agreed with the IMF on a pre-cautionary credit line. This was aimed at strengthening international markets confidence. Communication with the business community has improved and a number of economic and financial committees have been established to improve the economic dialogue. Cooperation with the World Bank and other IFIs continued. Structural reforms were further pursued in a number of areas. Overall, a broad political consensus on the fundamentals of economic policy has been maintained.

Macroeconomic stability

Real GDP rose by 1.8% in 2010, compared to a decrease of 0.9% the previous year. In 2011, output continued growing by 5.2% in the first half of the year. The main sources for growth shifted from net exports in the first half of 2010 to gross fixed capital formation in the second half of 2010 and the first quarter of 2011. In the second quarter of 2011, private consumption was the main driver for growth, increasing by 8.4% year-on-year, while equipment investment declined by 7.5%. As a result of the drop in investment, import growth slowed down in the second quarter, from 36.5% in the first quarter to 4.5% in the second. Export growth also decelerated, from 34.8% in the first quarter to 8.9% in the second. The strong growth in the first half of 2011 reflects a weak base in the previous year. The performance of industrial production and retail trade points to a marked year-on-year acceleration in the first half of 2011. Industrial production recovered in the first seven months of 2011, rising by 8.6% compared to the same period the year before. However, the overall level of industrial production is still lower than before the crisis. Average per capita GDP remained largely stable in 2010, at 35% of the EU-27. Overall, economic activity started to regain strength and depth since autumn 2010. However, government spending for construction played an important part in the strong rise of gross fixed capital formation.

The current account deficit widened, reflecting increased domestic economic activity. After a decline from -6.7% of GDP in 2009 to -2.8% in 2010, the mid-2011 current account deficit rose to some 3.5% of the estimated GDP of 2011. Higher imports were the main reason for the increase in the trade deficit. However, the rise in the current account deficit was accompanied by an even bigger increase in capital inflows, accounting in June 2011 to some 4.5% of the estimated annual GDP. The two main sources were capital inflows related to the partial use of the IMF pre-cautionary facility, amounting to some 3% of the estimated GDP and FDI inflows, which in the first quarter of 2011 were significantly higher than a year before. However, in the second quarter, FDI inflows were less buoyant, bringing the FDI inflows during the first half of 2011 to 2% of the estimated GDP for 2011.

Gross external debt was about 60% of GDP in the first quarter of 2011, compared to 56% of GDP a year before. The main source for the increase was public debt, which contributed 2.6 percentage

points of GDP to the increase. Private bank lending pushed up the external debt ratio by 1.4 percent points. Foreign reserves rose to €2.0 billion (29% of GDP) in August, reflecting a marked increase in FDI inflows, but also the partial drawing of the country's pre-cautionary credit line with the IMF. As a result, the reserve coverage of prospective imports recovered to close to three and a half months, although the strong increase in imports limited the improvement. Overall, external accounts registered a marked increase in the current account deficit, although this was more than offset by higher capital inflows, in particular FDI, but also by loans from the IMF and other international financial institutions.

Unemployment was very high during 2010, at 32% on average. In 2011, the labour market situation improved slightly, as unemployment fell to 31.4% in the first quarter of 2011. Employment increased by 5.5% year-on-year in the first quarter of 2011, (i.e. by 34,000 persons), compared to a decline of 0.4% in the previous year. The main sectors where there were employment gains were agriculture, but also manufacturing. However, new employment in agriculture is largely due to new registrations of subsistence farmers. The number of unemployed persons fell by 4.8% in the first quarter of 2011, i.e. a drop of 15,000. There is a positive trend in youth unemployment (age bracket 15-24 years), falling from 57.1% in the first quarter of 2010 to 52.5% in the first quarter of 2011. Youth unemployment as a share in total unemployment dropped from 20.1% in 2010 Q1 to 17.7% in 2011 Q1. A key factor for this decline was a big reduction in youth unemployment among women. Furthermore, easier access to higher education courses helped reduce unemployment rates. Even though the existence of a substantial informal sector means that actual unemployment may be overstated, the very high unemployment remains an important issue, in particular among young people and the less educated. Overall, the situation in the labour market has improved slightly, but unemployment continues to be very high, particularly among the young and less well educated.

Table 3.1:

The former Yugoslav Republic of Macedonia - Main economic trends		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	5.1	6.2	5.1	-1.0	1.8	5.2
Private consumption	Ann. % ch	6.0	9.8	8.1	-4.8	1.8	10.0
Gross fixed capital formation	Ann. % ch	11.6	13.3	16.5	0.5	-7.5f	N.A.
Unemployment	%	36.0	34.9	33.8	32.2	32.1	31.3
Employment	Ann. % ch	4.6	3.5	3.2	3.4	1.3	4.0
Wages	Ann. % ch	8.0	4.8	8.7	14.1	1.0	1.7
Current account balance	% of GDP	-0.4	-7.1	-12.8	-6.7	-2.8	-3.5
Direct investment (FDI, net)	% of GDP	6.6	8.5	6.1	2.0	3.2	2
CPI	Ann. % ch	3.2	2.3	8.3	-0.8	1.6	4.4
Interest rate (3 months)	% p.a.	6.40	5.60	5.30	N.A.	N.A.	N.A.
Stock markets	Index	3,219	6,971	5,149	2,497	2,472	2,589
Exchange rate MKD/EUR	Value	61.19	61.18	61.26	61.28	61.51	61.53
Nominal eff. exchange rate	Index	100.0	99.6	100.6	106.6	106.0	N.A.
General government balance	% of GDP	-0.6	0.6	-1.0	-2.7	-2.5	N.A.
General government debt	% of GDP	40.2	27.3	28.8	32.1	35.1	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Monetary policy cautiously supported the gradual recovery, while the exchange rate policy remained oriented towards maintaining price stability and the de facto peg to the euro. The Central Bank has continued to lower its key policy rates, such as the rate on 28-day Central Bank bills from 4.5% to 4.0%. Overall, the exchange rate policy and monetary policy have remained sound.

Inflation accelerated in the last quarter of 2010, reaching 3.0% at the end of the year, while the annual average in 2010 was 1.6%, as compared to -0.8% in 2009. The main factors driving the strong increase towards end-2010 were higher prices for energy, base metals and food. During the first three months of 2011, consumer price inflation continued to accelerate, driven by prices for food and transport services. However since then, inflation has been slowing down, declining to 3.6% in August. This brought average inflation to 4.2 for the first eight months of the year. Core inflation, which

excludes the impact of energy and food prices on the overall price level, was close to zero in 2010, but increased to around 1.3% in the first five months of 2011.

The overall fiscal policy stance has been oriented towards achieving the deficit targets. In order to reach the 2.5% deficit target for 2010, the authorities responded to lower than anticipated revenues by reducing spending on goods and services and strongly limiting the planned increase in capital spending. Consequently, the 2010 deficit target of 2.5% of GDP was reached, although revenues were 7.8% lower than envisaged. The deficit target for 2011 is 2.5%. In the first seven months of 2011, revenues as a share in GDP were on a similar level as a year before, while spending was slightly higher. This brought the accumulated central government deficit in July to about 2% of the year's estimated GDP, compared to a deficit of 1¼% of GDP the year before. However, a part of this increase reflects front-loaded spending, mainly in construction, related to early elections in June. The authorities have a solid track record of meeting prudent fiscal target. However, the quality of public spending suffers from still weak planning capacities and short-term oriented spending decisions, which delay the accumulation of productive investment. Higher deficits, but also increased public spending financed by debt, contributed to an increase in the public debt ratio, from 31.9% in December 2009 to 35.7% in December 2010.

Fiscal decentralisation has continued. By mid-2011, 79 out of 85 municipalities have advanced to the second stage of decentralisation. Furthermore, additional measures have been taken to strengthen the fiscal viability of indebted municipalities. The efficiency of the public administration still suffers from insufficient staffing, lengthy procedures, a high degree of political interference leading to high turnover of qualified staff. Overall, fiscal policy was oriented towards achieving its fiscal target, despite lower than expected revenue performance. The spending profile maintained its focus on transfers, although lowering its current spending for goods and transfers. Capital spending was raised slightly, however the growth and employment stimulating effect of this investment was reduced by the high import content of the spending.

As in the past, the overall macroeconomic policy mix was largely sound, Monetary conditions were still relatively favourable to growth, while taking into account the country's policy of a de facto peg to the euro. Public spending was largely kept in line with revenues. The structure of spending was broadly maintained, focussing on transfers, with a small increase in capital investment and a further reduction in current spending for goods and services. However, some of the capital investment could have been spent in a more growth supportive manner. Overall, the general policy mix continued to be sound, remaining stability oriented while trying to support the recovery. However, the quality of public finances has not improved significantly 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 share of state activities has remained largely unchanged. However, largely as a result of a fall in private activities, the share of the private sector declined, from 87% of total value added in 2008 to 86% in 2009. In terms of employment, the share of private sector employment dropped from 77.8% in 2009 to 77.2% in 2010. The share of administered and regulated prices in the CPI basket was down from 14.4% in 2009 to 13.1% in 2010, partly due to changes in the CPI basket. Most of those administered and regulated prices are cost recovering. The asset value of fully or partly state-controlled companies has remained at around 13.5% of GDP. The majority of this capital - nearly 80% - is concentrated in five companies, mainly public utilities such as the production and transmission of electricity, where the state is majority owner and telecommunication, where the state is a minority owner in the highly profitable incumbent telecom company. Overall, as a result of the crisis, the role of the state has increased, while state ownership has remained concentrated mainly on telecommunication, energy and public utilities.

Market entry and exit

The government has continued taking steps to facilitate market entry and exit. The second phase of the 'one-stop-shop' has been completed, improving in particular the possibilities for the electronic registration of mortgages, bankruptcy proceedings, documentation delivery etc. The costs of registration have been reduced further. The implementation of the third phase of the so-called 'business guillotine' aimed at simplifying regulation has continued. Contact with the business community was strengthened. The process of closing down unviable companies has continued. In the second half of 2010, the number of bankruptcy procedures was about one quarter higher than a year before. However, during 2011, the number of new bankruptcies has declined again towards pre-crisis levels. As a result of the rapid increase in the number of bankruptcy procedures, the backlog of pending bankruptcy procedures has increased in the second half of 2010, from 338 cases at the end of 2009 to 358 cases at the end of 2010. There is still room for a further shortening of bankruptcy procedures. Overall, some further progress has been achieved in reducing barriers to market entry and exit.

Legal system

The legal system for a functioning market economy is largely in place. Steps have been taken to increase the efficiency of courts, to improve the transparency of court decisions, to accelerate legal procedures and to improve enforcement of contracts, for example by transferring jurisdiction on payment orders to notaries. The registration of real estate ownership rights is practically completed. The number of pending court cases has been reduced from 6014 cases end-2009 to 5492 cases end-2010. Furthermore, the duration of court procedures has been reduced, with the percentage of cases solved within three months rising from 25% in 2009 to 36% in 2010, while the percentage of cases lasting more than one year has declined, from 17% in 2009 to 13% in 2010. Contract enforcement is still difficult, hampering the business environment, in particular for small-and-medium-sized enterprises. The introduction of electronic procurement has increased the transparency of public spending. However, despite strengthened legal and financial independence of regulatory and supervisory bodies, the administrative capacities and the enforcement record of some of those institutions, such as the railway regulatory agency, the energy and the telecom regulators, the agencies regulating and supervising the fully funded pension funds and the securities and exchange commission still need to be strengthened. Overall, the functioning of the legal system has improved, which should have a positive impact on the business and investment climate. However, weaknesses in the rule of law, particularly in the judiciary, which is characterised by slow procedures, insufficient resources and unreliable enforcement of contracts, and the prevalence of corruption, continue to adversely affect the business environment.

Financial sector development

The financial sector's significance and its intermediation function has increased, reflecting additional capital from foreign investors but also increased deposits and lending. In the banking sector, total assets as a share of GDP were up from 67% mid of 2010 to 69% of the estimated GDP by mid 2011. Credits as a share of GDP increased from 43.5% in October 2010 to some 45% of the estimated GDP end of August 2011, while the level of deposits rose from 48% end of October 2010 to around 50% of the projected GDP in August 2011. Deposits continue to be the sector's main source of liquidity. The coverage of loans by deposits is still above 100%. The sector continues to be predominantly owned by foreign companies with 14 out of 17 banks dominated by foreign owners. The share of foreign ownership has increased from 68.6% end of 2009 to 78% mid of 2011. 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. Market concentration remains high, but has decreased slightly during the past year. The assets of the five biggest banks as a share of total assets declined only marginally, from 77.4% end of 2009

to 77.2% end of 2010. However, the three biggest banks lost some market shares to medium-sized banks. The efficiency of the banking sector has remained largely unchanged. Profitability of the sector as a whole remains low, with slightly negative returns-on-assets and equity in the first quarter, and slight profits in the second quarter (0.2% return-on-assets, and 2.1% return-on-equity). However, larger banks performed better than smaller ones. Credit growth accelerated since autumn last year, reaching some 8% in August. Private-sector weighted interest rates declined following their peak in the last quarter of 2009. Rates for denar loans declined from 9.2% in September 2010 to 8.9% in July 2011, while the rates for denar deposits declined from 6.8% to 5.8%. As a result of the faster decline of deposit rates, spreads widened from 2.4 percentage points in September 2010 to 3.1 percentage points in July 2011. Financial stability has been maintained, with sound liquidity, solvency and capital adequacy ratios. The share of non-performing-loans has started to decline again, from a peak of 10.6% in September 2010 to 9.3% by end-June 2011

Banking regulation and supervision is largely in line with international standards. However, the proper functioning of regulatory and supervisory agencies, such as the Agency for the supervision of fully funded pension insurance (MAPAS) or the security exchange commission (SEC), is still hampered either by still insufficient financial independence and/or by insufficient human and IT resources. Furthermore, sometimes institutional competences are not sufficiently defined. As a result, the leverage of those institutions has not yet reached an adequate level. Transparency of the credit market has improved through the establishment of a private credit bureau, providing credit history reports.

The relevance of other financial market intermediaries is limited, with assets accounting for some 10% of the financial sector's assets or some 8% of GDP. Insurance institutions account for some 4% of the sector's assets, while leasing companies and pension funds account for about 3% each. The value of the capital market accounts for some 30% of GDP

Overall, the financial sector continued its gradual process of deepening and widening. However, the level of financial intermediation and competition in the market are still low, impeding more dynamic growth in the private sector, particularly for SMEs. Furthermore, some regulatory and supervisory agencies have not yet reached a sufficient level of independence, resource endowment and leverage.

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 continued global economic turbulence. Market entry and exit procedures have been improved and the rule of law has been strengthened. However, structural imbalances on the labour market are still very pronounced and the business environment is still suffering from slow judiciary, and a number of weak and not fully independent regulatory and supervisory institutions.

Human and physical capital endowment

The level of human capital endowment is still low. The authorities continued to improve both the physical infrastructure for education and the regulatory framework in order to improve the performance of the educational system. The number of teachers was increased by 4.4% in 2010, in particular in primary and lower-secondary schools. Enrolment rates have been improved. Budgetary allocations for education were marginally increased, from 3.7% of GDP in the 2010 budget to 3.8% in the budget for 2011. As in the past, spending has been focused on renovation and construction of school buildings and the purchase of IT equipment. Despite continued efforts, the overall level of education and training of the labour force is still relatively low and the mismatch of skills is still 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 calls for further sustained efforts in order to improve the country's human capital endowment.

The country's capital endowment continues to be relatively low and its quality is hampered by previous decades of underinvestment. The low level of education and the weak capital endowment contribute to a low general level of productivity. Some further progress has been made on improving transport infrastructure. Gross fixed capital formation showed a marked acceleration in the second half of 2010 and in particular in the first quarter of 2011. However, overall investment levels in 2010 and early 2011 were still lower than a year before. The stock of foreign investment stands at 51% of GDP. Foreign direct investment inflows increased markedly in the fourth quarter of 2010 and the first quarter of 2011, but were less buoyant in the second quarter. Overall, the interest of foreign investors in the country has improved. In some cases, persistently slow legal procedures, such as those involving work permits for foreign employees, or fragmentation of responsibilities between central and local governments continue to be an impediment to FDI. Spending on strengthening the knowledge-based economy has remained low. The accumulation of the public capital stock is impeded by weak implementation capacities, but also the use of funds for less productive purposes, such as the beautification of the capital. Overall, the country's capital stock continued to be low. Infrastructure improved, but it continues to require repair and modernisation.

Sectoral and enterprise structure

There were no major changes in the area of enterprise restructuring. Network industries, such as railways, energy production and transmission, are still state owned to a considerable degree. Recent amendments to the energy law adopted in spring 2011 should increase competition and transparency in the electricity sector. Gas and electricity markets are dominated by a very small number of suppliers, which undermines effective competition. In the telecommunication sector, the number of service providers has increased, leading to a lower market share of the incumbent operator for fixed-line and mobile telephony. There was no significant structural change in the transport sector.

The focus of economic activity has continued to move away from manufacturing towards services, in particular retail trade, and – recently - also towards construction. Manufacturing increased its share from 12.4% of GDP in the fourth quarter of 2009 to 14.4% in the fourth quarter of 2010, and construction rose from 5.6% to 7.8% of GDP. At the same time, the share of value added in agriculture declined, from 12.8% to 10.9% of GDP. In terms of employment, agriculture registered the highest employment gains in the fourth quarter, increasing its share from 16.7% of total employment to 19.2% while the share of manufacturing in total employment dropped from 23.9% to 22.5% in the fourth quarter of 2009. The increase in agriculture employment and the simultaneous reduction of the sector's productivity suggests an important share of 'administrative' job creation and not new capacities.

Small and medium-sized companies (SMEs) are by far the most important group of companies, providing employment for some 82% of private sector employees or 56% of total employment. In 2010, in line with the general decline in economic activity, the number of SMEs fell by 8.3%. This mainly reflected a sharp drop in the number of micro-enterprises, while the number of larger SMEs increased. In terms of employment, the number of employees increased by 1.5% in 2010, while among large companies employment declined by 14%. The availability of an EIB financed SME facility worth €100 million improved access to financing. Furthermore, the government is subsidizing interest costs for export oriented SMEs and has increased budgetary allocations for SME support schemes.

The informal sector, fuelled by weaknesses in tax and expenditure policies as well as in law enforcement, and the fight against corruption, remains a major challenge. It reduces the tax base and the efficiency of economic policies.

Overall, structural change towards diversification and activities with higher value-added has remained limited. Competition in network industries remains constrained by dominant incumbent suppliers. SMEs still face difficulties in accessing capital and markets despite increased support.

State influence on competitiveness

The overall level of systematic state intervention is limited. Official data point to a relatively low level of State aid, i.e. less than 1% of GDP. However, this figure is not comparable with the State aid data compiled in accordance with EU standards. The institutional setup for monitoring State aid and competition issues, the Competition Commission, is in place. However, the current resource endowment is still insufficient to cover the agency's full range of responsibilities. Overall, state influence on competitiveness remained limited.

Economic integration with the EU

The country has a small, open economy, with total trade in goods and services recovering to a level of 114% of GDP in 2010, following the 2009 recession. Trade integration with the EU is advanced, with about 63% of all exports currently going to and about 53% of imports originating from the EU. The CEFTA region is the country's second most important trading region, accounting for around 24% of exports and around 10% of imports. The export structure continues to be highly concentrated on a limited range of products, with textiles and clothing accounting for about 17% of total exports and manufactured iron products for 26% in 2010. The stock of FDI increased to about 51% of GDP, with the Netherlands, Slovenia and Austria being the biggest investors. In total, EU countries accounted for about 60% of total FDI inflows. Switzerland, Turkey and Serbia are the most important non-EU investors. The exchange rate against the euro has remained stable in nominal terms. Price competitiveness has remained largely unchanged. Overall, trade integration with the EU is well advanced, but exports remain concentrated on a few price-sensitive products. International price competitiveness remained largely unchanged.

3.3. Conclusions

The economy of the former Yugoslav Republic of Macedonia started to recover in the second half of 2010, benefitting from external demand and increased investment, in particular in construction. In late 2010, the government agreed with the IMF on a pre-cautionary credit line. This should strengthen international markets confidence. Structural reforms have continued. However, high structural unemployment, in particular among the young and poorly educated, remains a major cause of concern. Institutional capacities of the public administration and of regulatory and supervisory agencies are still inadequate.

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 facilitating company registration, accelerating judiciary procedures, improving the functioning of financial markets, further simplifying the regulatory framework and improving communication with the business community. The country 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. The economic dialogue with the business community has improved. The stance of monetary policy, based on the de facto peg to the euro, supported growth and contributed to macro-economic stability. Fiscal policy maintained its stability orientation. Some further progress has been achieved in facilitating market entry and in simplifying the regulatory framework. The duration of bankruptcy procedures has been further reduced and real estate registration is practically completed. The financial sector started to

recover from the global financial crisis. Competition in this sector has slightly improved, as well as the level of financial intermediation

Weaknesses in the rule of law continue to impede the proper functioning of the market economy. Public administration efficiency is still low, reflecting heavy procedures, weaknesses in staffing and a high turnover of officials. Some regulatory and supervisory agencies continue to lack the necessary independence and resource allocation to fulfil their functions effectively. Contract enforcement is still difficult, which hampers the business environment, in particular for small and medium sized enterprises. The quality of education and of the human capital is low. Physical capital needs further modernisation and deepening. The quality of fiscal governance has remained low, partly due to a strong short-term orientation of public spending. As a result, progress with reducing the very high structural unemployment has remained very limited. Public sector debt has increased, reflecting continued fiscal deficits and increased external lending. The informal sector remains an important challenge.

4. MONTENEGRO

The Commission's approach in its examination of economic developments in Montenegro 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

Montenegro has been playing an active part in the EC fiscal surveillance and reporting arrangements applying to potential candidate countries since 2006. It participated for the first time in the EU multilateral fiscal surveillance procedure for candidate countries, including the ministerial dialogue with the ECOFIN Council in May 2011. The country's 2011 Economic and Fiscal Programme presented a cautious macroeconomic baseline accompanied by an expenditure-based fiscal consolidation framework, plus a wide structural reform agenda that was consistent with past priorities. Meanwhile, a domestic political consensus was maintained on the fundamentals of a market economy. Overall, economic policy remained consistent.

Macroeconomic stability

The economy started to recover in 2010 from the effects of the crisis, growing by 2.5%, after contracting by 5.7% a year earlier. The first signs of revitalisation appeared in the second quarter of 2010 after 18 months of continuous contraction. Growth was driven by net exports, private consumption and changes in inventories. From the supply side, the turn around of the global metal market gave an additional boost to local industries, raising total industrial production by 17.5% in 2010. Manufacturing output accelerated further by 9.6% on average during the first seven months of 2011. However, the overall industrial production rose much more modestly, by 0.2% year-on-year in July, as the utility sector output still remained below previous year level by -30%. The construction sector accelerated rapidly in the last quarter of 2010, with the value of performed construction works expanding by 13% in 2010, compared with the contraction of 21% recorded a year earlier. The value of finalised construction works expanded in the first six months of 2011 by 30.8% year-on-year. Retail sales which had shown a modest increase in 2010 (1.6%) increased further during the first half of 2011 by 14.3% year-on-year. Average per-capita income in purchasing power standards amounted to 40% of the EU-27 average in 2010, down from 41% in 2009. Overall, a modest recovery of the economy is underway.

While domestic demand remained subdued in 2010, industry's recovery contributed to a 20% increase of total merchandise exports, with exports of aluminium accounting for 41% of this increase. At the same time, merchandise imports remained virtually flat. As a result, the large trade deficit dropped to 42% of GDP in 2010, from 46% a year earlier. After a successful tourism season the surplus in services increased by 16%, supporting the contraction of the current account deficit in 2010 down to a still very high 25% of GDP, from 30% a year earlier. The current account deficit contracted further during the first half of 2011 by 12.5% year-on-year to 22.4% of GDP in annualised terms. The improvement was mainly driven by a widening surplus on the services and income accounts. In 2010 the current account deficit was largely covered by net FDI and net portfolio investments, contributing 17% and 6% of GDP respectively. In the first half of 2011 net FDI inflows contracted by 45% year-on-year to 13% of GDP or 60% of the current account deficit. The surge in net portfolio investments during the same period contributed with additional 11% of GDP, financing 40% of the deficit. Overall, despite the continuous expansion of merchandise exports, these still remain below pre-crisis levels.

Unemployment in 2010 remained high at 19.7%, up from 19.1% a year earlier. Employment contracted by 7.1% in the same period. The unemployment rate continued growing in 2011. It reached 19.9% in the second quarter of 2011. According to the Agency for Employment (AEM), recorded employment improved during the first half of 2011; increasing by 6.6% year-on-year, while job vacancies increased by 18% year-on-year. The AEM registered unemployment rate decreased to 11% in July 2011, down from 12.2% at the end of 2010. There remain significant discrepancies in labour statistics between Labour Force Surveys (LFS) and the Agency for Employment (AEM) administrative records. Further efforts are also needed to address the high level of informal employment, estimated by the AEM at 20% of total employment in 2010. Overall, the labour market deteriorated during 2010, but shows mixed signs of improvement in 2011.

Consumer prices remained subdued during 2010, thanks to a reduction in food prices, and the reduction of annually adjusted electricity prices. Headline inflation averaged at 0.5% in 2010 and picked up slightly to reach 0.7% year-on-year in December. Inflation accelerated further in 2011, averaging 2.9% on the first seven months of the year driven by food, transport, health and communication prices, as well as the increases in excise rates on alcohol and tobacco. Overall, price stability was generally maintained amid recent external pressures.

Table 4.1:
Montenegro - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	8.6	10.7	6.9	-5.7	2.5	2.5e
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	-7.7	4.2	:
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	-25.3	-21.2	:
Unemployment	%	14.7	11.9	10.7	11.4	12.2	11.3
Employment	Ann. % ch	4.5	3.7	6.3	4.8	-7.1	5.6
Wages	Ann. % ch	15.6	14.2	22.8	5.7	11.0	3.8
Current account balance	% of GDP	-24.7	-39.6	-51.3	-30.1	-25.1	-22.4
Direct investment (FDI, net)	% of GDP	21.7	20.8	18.9	35.8	17.5	14.9
CPI	Ann. % ch	3.0	4.3	7.4	3.4	0.5	2.9
Interest rate (6 months)	% p.a.	1.30	:	:	3.63	3.37	2.71
Stock markets	Index	14,406	36,159	19,947	13,303	13,993	13,308
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	3.4	6.6	0.5	-4.4	-5.0	-1.6
General government debt	% of GDP	32.6	27.5	29.0	38.2	40.9	44.9

Sources: Thomson Reuters/Ecowin, Eurostat

Unilateral euroisation implies that there is only limited scope for the use of domestic monetary policy instruments. The Central Bank's capabilities as lender of last resort are restricted and the ultimate stability of the financial system relies on its banks' supervision and on the soundness of the government fiscal policy. The banking system seems to have stabilised somewhat in 2010 and the Central Bank has been strengthening its supervisory capacities. Bank deposits contracted by 1.9% in 2010 but they recorded positive growth rates during the first half of 2011. However, the aggregated level of bank loans remained in negative territory during the same period, contracting by 12.4% year-on-year at the end of June 2011. The seven mid-sized and smaller banks recorded 12% annual credit growth in the first half of 2011, while the four largest registered 32% contraction. Overall, the largest banks could not support the economy by providing new credits as they were pursuing their consolidation.

In 2010, the consolidated budget deficit stood at 5% of GDP, including tax arrears worth some 2% of GDP. Moreover, the level of contingent liabilities due to extended guarantees represented 10.3% of GDP at the end of 2010. Budget revenues totalled 42% of GDP. The effects of the crisis translated into the contraction of 1.8% in VAT revenues and tax receipts down by 5.1%, plus the sharp 63% contraction of corporate income tax owing to the weak financial position of businesses. Revenues from personal income tax, social security contributions and local taxes exceeded the plan. Public

expenditures reached 45% of GDP, as gross wages increased by 2.4% and social protection transfers (mostly pensions) by 4%, while subsidies contracted by 12% compared with the planned spending level. Implementation of capital expenditure remained flat and lower than planned as the highway works were postponed. The consolidated deficit reached 1.6% of GDP in the first half of 2011. Public debt without state guarantees accounted for 41% of GDP in 2010 as against 38% a year earlier. The increase was a consequence of the rapid expansion of the external debt, which accounts for 72% of the total. The public debt increased further following the new issue of Eurobonds in April 2011, reaching 45% of GDP by the end of June. Overall, past efforts at expenditure control have resulted in large arrears accumulation and led to substantial contingent liabilities.

The global economic and financial crisis has posed a challenge to Montenegro's policy framework. The fact that Montenegro is using the euro as its sole legal tender, and has therefore abandoned standard monetary policy tools, leaves fiscal policy as the main effective policy instrument. The quality of public finances was improved with the adoption of important structural reforms, such as the public pension system, the streamlining of public employment, or a new financing scheme for local self-governments, although the full effect of these reforms will take still some time to get through. The Montenegrin economy remains constrained by limited diversification and competitiveness. Overall, despite the implicit constraints in the form of a limited set of policy tools, the overall macroeconomic stability improved compared to 2010.

Interplay of market forces

The majority of state ownership in the economy remains predominantly concentrated in transport (rail, port, airline and airports), and to a lesser extent in the metal and electric power industries, as well as in a few miscellaneous companies. In 2010, only maritime operator services of the port of Bar were successfully privatised, as well as some property of tourist company Budvanska Rivijera and the Bijela shipyard. The privatisation process suffered from the global crisis. Some companies repeatedly failed to attract interest from investors (in the case of the port container terminal and rail cargo due to the need for prior reconstruction of the railways) or went into bankruptcy proceedings (the steel mill and the tobacco factory). In August 2011 Italian power utility A2A, which owns 44% of Montenegro state power company EPCG, waived its right to acquire majority ownership after the government reversed a 2009 decision to majority-privatise the company. Overall, majority state ownership remains concentrated in network industries.

Only a limited number of products are currently subject to administrative price control, including medicines, bread and fuels. Meanwhile the Energy Regulatory Agency (ERA) establishes electricity prices in relation to production cost thresholds. In addition, local authorities may control the prices of certain utility services (water supply, sewerage, refuse collection). In the absence of controls on the price of food other than bread, the government approved the payment of two one-off cash benefits in 2011 (totalling € 2 million) targeting the most vulnerable social groups. Administered prices accounted for 10.7% of the harmonised index of consumer price (HICP) in 2010. Overall, the influence of the state in price dynamics remains limited.

Market entry and exit

In 2010 there were 3,695 new companies registered in Montenegro, which is an increase of 6.8% in the number of new registrations compared with 2009. Improvement in market entry was achieved with the establishment in May 2011 of a 'one-stop shop' for new company registration and simultaneous tax and customs listing instead of having to deal with three different institutions and procedures as was previously the case. So far, registration is possible at the central registry of the commercial court, but not yet at the regional units of the tax administration. Additional support to the business environment was provided in the form of amendments to the Law on Administrative Fees adopted in March 2011, which reduced or simply abolished payment for a series of administrative and customs documents.

The number of bankruptcy cases in 2010 fell to 2,196, compared to 6,150 a year earlier. A new Bankruptcy Law came into force in January 2011. The new law significantly shortens deadlines and enables submitting a legally enforceable restructuring plan together with the bankruptcy petition, against which creditors' claims are to be settled. Another novelty is the possibility for the debtor's company to be sold as a single legal entity, which increases its chances of survival. Overall, market entry and exit mechanisms were further improved.

Legal system

For the acquisition of real estate the Property Relations Law and the entry into force of the Stabilisation and Association Agreement provide the same treatment to both EU citizens and nationals. The Law on State Surveying and Immovable Property Cadastre was adopted by the parliament in June 2011. The main improvement concerns the shortening of deadlines for registration of immovable property to eight days compared with thirty days before, while authorities are obliged under the new law to make a decision within fifteen days of the submission of the request. Meanwhile, the modernisation of the current cadastre register continues with the addition of a newer digitalised information system. Overall, property registration procedures continue to improve.

In July 2011 the parliament adopted the Law on Enforcement and Securing of Claims. The new law shortens delays in procedure and recognises mortgage contracts and notarial deeds as enforceable documents. It also allows enforcement against immovable property, including their public sale within a limit of 50% of its market value. Enforcement against monetary claims is also tightened up. Although the strategic and legislative framework to combat corruption has been strengthened, its implementation remains uneven and corruption continues to be a cause for concern. Overall, the new law on Enforcement and Securing of Claims laid the basis for swifter enforcement of contracts. However, weaknesses in the rule of law and prevalent corruption continue to have an adverse effect on the business environment and remain a major challenge.

Financial sector development

Total bank loans accounted for 71% of GDP in 2010, compared to 80.4% the year before. Loans to the private sector remained constant at 98% of total credit. The ownership structure is largely dominated by foreign capital (83% of total), followed by private domestic shares (15%) and state ownership (2%). The banking sector remains highly concentrated, with four banks accounting for 68% of total assets. Financial intermediation remained subdued until May 2011 when two of the largest banks recovered from a long period of credit inactivity. In the case of Crnogorska Komercijalna Banka (CKB) it had to clearout its balance sheet, while Prva Banka's lending was banned by the Central Bank for a period of two and half years until the bank was recapitalised and improved its liquidity. The Central Bank has remained very active, developing secondary legislation with a view to strengthening the resilience of the system to future shocks. In 2011 it adopted several decisions, namely on open market operations, on conditions for lending to banks to maintain their liquidity, on approving last resort financial aid to banks, on international reserves management, on the establishment of the Investment Committee, on capital adequacy and, on mandatory reserves. Overall, financial legislation improved.

The interest rate spreads have been widening, as lending rates have been rising (from 9.63% in 2010 up to 9.72% in June 2011) while deposits rates contracted from 3.26% in 2010 to 3.06% in June 2011, the latter trend reflecting an overall improvement of banks' liquidity. The capital adequacy ratio (CAR) rose from 11% in 2009 to 15.9% in 2010 and 15.3% in June 2011, remaining above the minimum legal threshold of 10%. However, the share of non-performing loans (NPL) raises concerns. It has been increasing, reaching 25.3% of total loans in June 2011. Some banks still recorded losses and weak profitability. In the first half of 2011 the aggregated loss of banks totalled €9 million, compared to 47 million losses a year earlier. At the end of 2010, the combined return on average

assets (ROA) was 2.7% and the return on average equity (ROE) 27.3%. During the first half of 2011 the situation improved relatively, recording ROA of 0.6% and ROE of 6.3% by the end of June. Overall, the financial situation of the banking sector and the increasing share of non-performing loans continued to reflect the fallout of the crisis, and remain a cause for concern.

The leasing market remained virtually stagnant during 2010 as the value of their contracts was less than 0.9% of GDP compared with 1.1% a year earlier. Leasing showed signs of recovery in the first half of 2011, expanding by 3.3% year-on-year. The insurance market recorded a new entrant in 2011, raising the number of active companies in the country to 12. However, the sector still remains highly concentrated, with one company accounting for 53% of total premiums. Non life insurance dominates the market (86.6% of the total in 2010), of which compulsory motor vehicle insurance accounts for 56%. In 2010, the combined turnover of the two stock exchanges experienced a sharp contraction of 86% year-on-year, mostly as a result of the high base level following the partial privatisation of the electric power company a year earlier. In October 2010 the two stock exchanges merged to form the Montenegro Stock Exchange, operating as a single entity from January 2011 onwards. The parliament adopted a law on takeover of joint stock companies in March 2011 to improve the protection of shareholders, while streamlining takeover procedures. In June 2011, the Securities Commission issued the first licence to a domestic brokerage company for margin trading. The stock market turnover further declined in 2011, contracting by 31% year-on-year in August. Overall, non-banking financial institutions continued to play a limited role as a source of private sector financing.

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

Existence of a functioning market economy

The financial sector has still to recover from the fallout of the crisis. The persistence of external and internal imbalances and the risks as regards public finances from contingent liabilities present a challenge for the economy. Unemployment remained high. The stabilisation measures taken, coupled with a prudent fiscal stance, have reinforced the overall macroeconomic stability. Overall, market mechanisms endured the global turmoil but potential vulnerabilities remain.

Human and physical capital endowment

The reform of the education and training system remains very important given the mismatch of skills with the labour market and the need to improve competitiveness. Reforms have been focused on vocational education and training (VET) following the adoption of the amendments to the Law on VET in July 2010. Several education programmes have been prepared and updated: one for lower vocational education, 31 for three-year VET, 65 for four-year secondary VET and one for higher VET. Furthermore, social partners (trade unions and employers association) as well as the chamber of commerce and the employment agency have been also more involved. In order to align market needs more closely with academic curricula, three sectoral commissions (construction, agriculture and tourism) were established in 2010, tasked with proposing the development of VET qualifications. Overall, education reforms continued.

Almost 70% of the needs for seasonal employment are covered by foreign workers. In June 2011 the parliament amended the Law on Employment and Work of Foreigners, simplifying administrative procedures for contracting foreign labour. Active employment measures carried out during 2010 included programmes for education and professional training, public works programmes, credits for self-employment, as well as other activities such as career guidance, specialisation courses, etc. Overall, progress was recorded in the form of an improvement in several aspects of the labour market, but efforts should be sustained in order to increase labour participation rates.

Half of total public investments in physical capital are allocated to the national roads programme, representing some 2% of GDP in both 2009 and 2011. Investments on railways infrastructure (around 1% of GDP per year) are largely concentrated in reconstruction of existing sections, mostly financed from loans from International Financial Institutions. Total public investments in airports, telecommunications and the port of Bar represented less than 0.3% of GDP. As regards telecommunications, broadband connections rose by 4% during 2010, raising the penetration ratio to 35%. The incumbent Crnogorski Telekom enjoys a 98% share of the fixed telephony market, and m:tel 2%. In May 2011, the government adopted the plan for the development of business zones, enabling municipalities to create communally equipped areas for the establishment of entrepreneurial activities. Overall, the country needs to invest further in modernisation and the development of human capital and infrastructures in order to support domestic companies in their efforts to expand into foreign markets.

Sectoral and enterprise structure

Two of the main domestic manufacturing industries (aluminium and steel) have launched major restructuring programmes in the past few years. However, although the KAP aluminium factory managed to implement its expensive social programme and return to pre-crisis production growth rates, the ironworks company Zeljezara Niksic succeeded in modernising its working capital but failed to agree on the implementation of the social programme after two years of negotiations with the trade unions. This led to insolvency proceedings in April 2011 and the immediate implementation of a social programme for a majority of its 1,410 employees (by the end of August some 750 of them had already received redundancy payments). The company has presented a restructuration plan to be decided upon by the commercial court in early October. As for network industries, following the unbundling of the operations and infrastructure services in the Port of Bar and the railways, reforms are currently focused on implementing their social programmes ahead of a new attempt at privatisation. In the energy sector, the power grid operator (CGES) increased its share capital in January 2011 with the entry of an Italian investor providing a 22% stake whereas state ownership decreased to 55%. Reforms in the telecommunications industry were focused on technological upgrading. Overall, the ongoing restructuring in several key industries established the basis for further investments.

The contraction of employment recorded during 2010 affected mostly the manufacturing, construction and extraction industries as well as agriculture. As a result, the share of employment in industry and construction contracted to 20% in 2010 from 21% of total employment a year earlier and the primary sector to 6.2% from 6.5% in 2009. Meanwhile, the share of employment in services increased further to 74% in 2010 compared to 73% in 2009. The informal sector, fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption, remains large. Overall, the sectoral structure of the economy continued to shift towards services. The informal sector presents an important challenge.

Data from the Tax Administration show that there were 27,515 SMEs active in 2010, of which micro-enterprises are the predominant group, representing 53% of the total, followed by entrepreneurs (including those registered as self-employed) with 39%, small enterprises with 6% and medium-sized enterprises with 2%. SMEs account for 73% of total employment in the country, although the average size of these companies is quite small as most of them take on fewer than 10 workers. Their share of total exports remains slightly above 30% of total exports. Given that they find access to credit more difficult, the public Investment Development Fund started in 2010 to support SMEs by means of bank guarantees and credits co-financed with commercial banks. It facilitated 107 loans in 2010 for a total of € million, plus an additional € million from associated commercial banks. The Fund's activities have been extended in 2011 by a € million factoring facility, the establishment of a guarantee fund covering up to 50% of SMEs loans with commercial banks, as well as a budget of € million to support agriculture businesses. These subsidised loans for agriculture have a proportional larger

impact in a sector that attracted but 0.4% of total commercial loans in 2010 (or €9 million). The weak quality of credit portfolios of the domestic banks and risk aversion has led to persistently high lending interest rates (9.2% on average). The high cost of finance remains a major obstacle to setting up and developing companies. Overall, a significant share of entrepreneurial activities remains concentrated in non-tradable services.

State influence on competitiveness

Total State aid granted in 2010 amounted to €72 million, or 2.3% of GDP. Of this, around two thirds were allocated to the aluminium factory KAP. The Niksic steelworks received additional 7%, but the call for insolvency proceeding in 2011 put an end to the subsidies to this company. Other companies, like the tobacco factory, the daily newspaper Pobjeda or the national TV broadcaster, received each less than 2% of this aid. Following the surge in global oil prices, the government also introduced in May 2011 a temporary scheme for the partial refund of excise duties on fuel for agriculture machinery, construction, transport and food processing industries. Overall, direct State aid has been declining, although the sizeable amount of state guarantees cumulated in the last years remain a matter of concern.

Economic integration with the EU

Openness of the economy, defined as the total value of exports and imports of goods and services, increased slightly in 2010 to 99% of GDP. The main foreign destination for domestic products remains the EU, which accounted for 56% of total merchandise exports in 2010 (up from 48% in 2009), followed by CEFTA countries with 34% (down from 40% in 2009). Yet, most of Montenegro's imports originated from neighbouring CEFTA countries, with 40% of total trade in, compared with 38% from the EU. Import shares from both regions remained practically unchanged in 2010 compared with the previous year. Investments from the EU-27 represented 50% of total FDI inflows in 2010, compared with 80% a year earlier, largely reflecting the deal by the electric power company with Italian investors in 2009. Real effective exchange rate (REER) estimates based on inflation (CPI) suggest that, following a period of substantial appreciation in 2009, international competitiveness stabilised during 2010. Overall, trade openness and integration with the EU remain substantial.

4.3. Conclusions

The economy of Montenegro started to recover in 2010 from the effects of the crisis which challenged the country's economic policy framework. The absence of standard monetary policy tools left fiscal policy with the difficult mission of striking a balance between restoring growth and proceeding with consolidation. Nevertheless, the country managed to improve overall macroeconomic stability and the quality of public finances, and kept up the pace of reforms. The recovery process of the Montenegrin economy is still fragile. The competitiveness of the economy remains limited with low diversification across the sectors. Shortcomings remain concerning the rule of law, public administration, human resources and infrastructure.

As regards the economic criteria, Montenegro has made further progress towards a functioning market economy as a result of progress in stabilising the banking sector and maintaining a relatively prudent fiscal stance, thus reinforcing macroeconomic stability. Montenegro should be able to cope with competitive pressures and market forces within the Union in the medium-term, provided that it addresses existing structural weaknesses through the implementation of its reform programme.

The recovery of export-oriented industries stimulated economic growth and, together with subdued domestic demand and positive developments in tourism, contributed to a reduction of the still high external imbalances. The economic policy remained consistent and some structural reforms advanced. The reform of public pensions is a step towards a higher quality and sustainability of public finances.

Market entry and exit mechanisms, contract enforcement as well as business and property registration procedures were further improved. Financial legislation was developed with a view to improving the resilience of the sector.

However, the financial intermediation role of banks remained subdued as banks pursued the consolidation of their balance sheets. The very high share of non-performing loans remains a serious concern for financial stability. Businesses continue to be confronted with tight and expensive credit conditions. Unemployment is high. Budget financing needs led to the expansion of public debt while contingent liabilities from state guarantees and budget arrears increased significantly. The privatisation process suffered from the negative global environment. Besides tourism and exports of commodities, economic activity remains concentrated on non-tradable sectors. The informal sector remains an important challenge. Persisting weaknesses in the rule of law negatively affect the investment and business environment.

5. 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.

5.1. The existence of a functioning market economy

Economic policy essentials

Turkey's economic policy is tailored to maintaining an open, largely market-driven economy with relatively prudent public finance management and a well regulated financial sector. The Pre-Accession Economic Programme (PEP) submitted to the Commission in April 2011 adequately reflects needs and commitments to further reform. However, it drew to too large an extent on the Medium-Term Plan (MTP) already published in mid-2010. Turkey's economic governance still has to focus on the imbalances emerging from the stronger than anticipated recovery and on further structural reforms, some of which, particularly in taxation and employment, are expected from the new government, which took office after the June 2011 elections. The fragmentation of responsibilities between government bodies continues to complicate coordination of budgeting and medium-term economic policy-making. The authorities are stepping up their efforts to enhance cooperation through the establishment of a financial stability committee. Overall, the consensus as regards the fundamental goals of economic policy remains firm.

Macroeconomic stability

After a steep recovery in 2010 when the Turkish economy grew by 9% year-on-year, the rapid economic expansion continued with 10.2% year-on-year GDP growth in the first half of 2011. Economic activity bounced back strongly, which reflected some base effects, but also strong domestic demand growth driven by low real interest rates, strong capital inflows and a rapid acceleration in the growth in bank credit. The private sector remained the main driver of the recovery. In the first half of 2011, private consumption rose by 10.8% year on year, with private-sector investment, which accounts for about 15% of GDP, expanding by a remarkable 31.3% year on year. In spite of the June Parliamentary elections, government consumption remained restrained and posted a first-half increase of 7.3% year-on-year. The sharp increase in domestic demand was accompanied by a further deterioration in the trade and current account balances. Exports of goods and services rose by 4.2% year on year, while imports of goods and services grew at an accelerated rate of 23%. All major sectors of the economy contributed to growth in 2010/11. The largest increases in gross value added came from construction and manufacturing. Turkey's GDP measure (at purchasing power parity) per inhabitant stood at 48% of the EU average in 2010. Overall, the economy expanded rapidly in 2010 and in the first half of 2011, mainly driven by strong domestic demand.

The current-account deficit, which tripled to a record of 6.6% of GDP in 2010, continued to widen in the first half of 2011. The increase was entirely due to the deterioration of the merchandise trade deficit, which more than doubled compared with a year earlier. Strong domestic demand and high global commodity prices continued to boost the import bill, notwithstanding the Central Bank's efforts to curb credit growth and the recent relative weakness of the Turkish lira. Exports to some countries in political crisis started to fall and, according to customs-based data, exports to North Africa declined by about 10% year on year in the first half of 2011. At the same time, sales to almost all other regions recorded strong growth. The balance-of-payments data also included high positive capital inflows from crisis-ridden countries in the Middle East, which are reportedly as high as €10 billion in the first six months of 2011. According to Central Bank data, official gross foreign-exchange reserves have

stayed on an upward trend in 2011, and amounted to €68 billion by mid 2011. This was also a result of continued inflows on the portfolio side (especially bond issuance), but more importantly of the access by the corporate and banking sectors to ample financing. Overall, imports have been rising due to strong domestic demand, thus considerably increasing trade and current account deficits. External imbalances have become significant.

Table 5.1:

Turkey - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	6.9	4.7	0.7	-4.8	9.0	10.2
Private consumption	Ann. % ch	4.6	5.5	-0.3	-2.3	6.7	10.8
Gross fixed capital formation	Ann. % ch	13.3	3.1	-6.2	-19.0	29.9	31.3
Unemployment	%	9.9	9.9	11.0	14.1	12.0	10.5
Employment	Ann. % ch	-0.4	-3.6	1.3	0.4	6.2	6.6
Wages	Ann. % ch	10.9	9.8	11.7	9.9	10.8	8.2*
Current account balance	% of GDP	-6.1	-5.9	-5.6	-2.3	-6.5	-9.2
Direct investment (FDI, net)	% of GDP	3.6	3.1	2.3	1.1	1.1	1.3
CPI	Ann. % ch	9.6	8.8	10.4	6.3	8.6	5.1
Interest rate (3 months)	% p.a.	18.07	18.85	18.04	10.68	7.95	8.25
Stock markets	Index	39,867	48,270	37,582	37,510	59,484	65,065
Exchange rate TRY/EUR	Value	1.80	1.78	1.91	2.16	2.00	2.21
Nominal eff. exchange rate	Index	26.2	26.7	25.8	23.2	24.3	N.A.
General government balance	% of GDP	-0.1	-1.0	-2.2	-5.7	-3.6	N.A.
General government debt	% of GDP	46.1	39.4	39.5	45.5	41.6	N.A.

* Industrial Sector Q1

Sources: Thomson Reuters/Ecowin, Eurostat

In 2010, the unemployment rate amounted to 11.9%, down significantly from 14% in 2009. This trend continued in the first months of 2011, and in May 2011 the jobless rate stood at 9.4%, which represented a 1.6 pps improvement over the same month one year earlier. The non-agriculture unemployment rate showed a broadly similar trend. The youth unemployment rate dropped faster, most likely as a result of the priority the government gave to this segment in the employment package. Nevertheless, youth unemployment remains high at 21.7%. Employment data for 2010 show a marked improvement, as the number of employed persons increased by over 6% compared with 2009. Overall labour participation amounts to 49%, with a significant gender imbalance. While the labour participation is around 70% for men, it is below 30% for women. Despite the fact that there is such a low proportion of the female population actively looking for work, the female unemployment rate is only slightly higher than the male unemployment rate. In addition, about one third of women who are considered as employed are unpaid family workers in the agricultural sector, which reduces the percentage of women of working age who are employed and receiving an income to only less than 15% of the total. The labour markets need to absorb the unemployed and about one million new entrants every year. Overly strict employment protection laws discourage employers from hiring new people. The prevalence of undeclared work remains a major challenge. Overall, robust economic development allowed strong employment growth and a sizeable drop in unemployment.

Consumer price inflation was down from 6.5% in 2009 to 6.4% in 2010, remaining slightly below the official target of 6.5%, while annual core inflation rates surged to 6.4% in 2010 from 3.0% in 2009. Producer prices rose from 5.9% in 2009 to 8.9% in 2010. In the first five months of 2011, consumer price inflation proved highly volatile, hitting a 30-year low of 4% in March before picking up to reach 6.7% in August, largely on the back of strong base effects and volatile food prices. The combination of strong domestic demand, high world prices for fuel and food and a weaker currency can be expected to push inflation up further. Recently, the Central Bank revised its year-end inflation forecast upwards to 6.9%, significantly above the 5.5% inflation target, but still within the two percentage points inflation tolerance band. It cited higher-than-expected global oil prices and changes in customs duties (an increase in customs duties on many textile products took effect in July). Assuming 'limited additional monetary tightening' in the second half of the year, the Central Bank expected the annual inflation rate to rise in the second quarter, fall in the third quarter and rise again in the fourth quarter.

Overall, inflation has been in a volatile and upward trend, in large part due to pressures arising from energy and food inputs and buoyant economic activity.

Given the strong inflationary pressures and the rapidly deteriorating current account balance, gauging monetary policy is becoming more complicated by the day. The Central Bank of Turkey (CBT) has altered its monetary policy stance by combining relatively low interest rates, a wide interest rate corridor and high commercial bank reserve requirement rates (RRR). Since October, when the CBT first raised the RRRs by an average of 50 bps, it has also increased the RRRs on short term Turkish Lira deposits by an average 11 pps and foreign exchange deposits by an average 12 pps. The aim was to increase the cost of funding for banks and to curb credit growth in order to slow down the economy. Moreover, the CBT reduced the policy rate to 6.25% from 7.0% and widened the gap between overnight borrowing and lending rates by increasing the borrowing rate to 9.0% and decreasing the lending rate to 1.0% to discourage short-term inflows. So far, the CBT has been only partially successful, as the exchange rate has weakened somewhat, but RRR increases have failed to slow credit growth which - along with higher commodity prices - continues to feed Turkey's growing current account deficit. Given the momentum in the economy and the still rapid growth of credit, this degree of tightening has not shifted the drivers of growth away from domestic demand. More support from the fiscal side, and some specific and targeted macroprudential measures are being put in place, including by the banking regulator, in order to help engineer a soft landing of the economy and ease the burden placed on monetary policy. In August 2011, the CBT reduced the policy rate further from 6.25% to 5.75%, and decreased the gap between overnight borrowing and lending rates, arguing that, in view of the slowdown observed since the second quarter of 2011, there is a need to protect domestic economic growth. Overall, monetary policy has been only partially successful, as it was unable to sufficiently curb the growth of credit, which - along with high commodity prices - continues to feed Turkey's growing current account deficit.

The budget performed much better than expected in 2010 and the first half of 2011, especially due to the robust recovery in domestic demand, which provided significant support to indirect tax revenues. Overall real tax revenues rose by 35% year-on-year in 2010, and real expenditure grew by 15%. Consequently, the primary surplus almost tripled and the overall central government budget deficit fell by about half from 5.7% of GDP in 2009 to 3.6% of GDP in 2010, which was much better than the level of 4.7% of GDP which was originally budgeted. In the first half of 2011, strong demand continued to support the budget performance, as revenues increased by double digit rates. Lower interest payments, as well as delays in payments and the use of funds entered under the 2010 budget, may also have helped to hold down expenditure despite a significant real rise in personnel costs and some other current spending items. According to the medium-term fiscal plan, the government expects a budget deficit of 2.8% of GDP in 2011. Extra revenues collected from a tax amnesty programme, if saved, would take the 2011 deficit even lower. Targets have not been adjusted for economic growth figures and revenues which were higher than anticipated. Therefore, fiscal policy may have more scope to support the monetary policy efforts aimed at curbing the current account deficit. The public debt stock fell significantly in 2010, thereby in large part offsetting the increases observed since 2008, and it amounted to 41.6% of GDP by the end of 2010. The government announced a tax amnesty in June 2011 and expects an additional revenue of €6.8 billion (about 1% of GDP) this year, which would be primarily used for debt reduction. Overall, consolidation of public finances is on track.

Renewed efforts have been made to provide more efficient and transparent high quality public services and budgeting, including the adoption of a new law on the Turkish Court of Accounts (TCA) and the new law on State Aid. However, there is scope for further improvement, as the government could be more transparent and provide the public with more detailed information on the central government's budget and financial activities during the budget year. Four years after the adoption of the Public Financial Management Law, some components are still missing, in particular measures to enhance the accountability, efficiency and transparency of the budgeting process. This makes it difficult for citizens to hold the government accountable for its management of public money. The

unification of all tax administration functions under the Revenue Administration which had been previously announced has not yet been fully implemented. The aim of this unification was to strengthen the audit capacity and facilitate greater use of standard risk-based audit techniques, thereby enhancing transparency and reducing informality. The adoption of a strong fiscal rule may not only enhance fiscal transparency, but also provide a strong fiscal anchor and enhance credibility. Overall, modest efforts were made to increase fiscal transparency.

Turkey's fiscal and monetary policy mix proved successful during the crisis. Although the Turkish economy was hit hard by the financial crisis, the earlier regulatory and supervisory reforms have paid off and there was a rapid resumption of strong growth. However, Turkey did not fully benefit from the recovery owing to insufficient adjustments. Making more progress with fiscal transparency, adjusting the fiscal and monetary policy mix, doing more to target inflation and preserving financial stability will be important ways to minimise the risks of a boom-bust scenario. Overall, macroeconomic stability remains vulnerable and could benefit more from a better coordinated tightening of the policy mix.

Interplay of market forces

Regulatory and surveillance agencies are in place in all major sectors. Automatic pricing mechanisms are operational in the natural gas and electricity sectors, where end-user prices are supposedly linked to a cost-based methodology. The share of administrated prices in the Consumer Price Index (CPI) basket currently amounts to only 4.5% of the total weight of the CPI basket. However, before the Parliamentary elections in June 2011, the government did not allow global price changes to impact on electricity consumption and natural gas prices during a period of one year, thereby effectively suspending automatic pricing mechanisms. Despite the regulatory framework, government authorities still tend to set prices in the transport sector, in particular for civil aviation. Liberalisation of backbone services, in particular in the energy sector, prepared the ground for several successful privatisations in this sector, enabling Turkey to continue its privatisation efforts in the challenging aftermath of the financial crisis.

The volume of completed privatisation transactions rose from €1.6 billion in 2009 (0.4% of GDP) to €2.3 billion (0.7% of GDP) in 2010. Major deals completed in 2010 included the privatisation of two ports, a salt mine, and six electricity distribution companies. Ongoing privatisations include major electricity generation assets, highways, bridges and ports. Sales of remaining shares in Turkish Airlines, Turk Telekom, Petkim, and the partly state-owned banks Halkbank and Vakifbank, have been scheduled, whereas there is no plan yet for Ziraatbank and the national lottery. Overall, the free interplay and functioning of market forces has been confirmed. Spurred on by recovery, privatisation has gained momentum.

Market entry and exit

In 2010, the business registration process was further streamlined. As a result, it now takes on average only 6 days to open a business. However, starting a business in Turkey is costly and corresponds to 17.2% of per capita income. Some fees are not transparent, such as those for the official registration of a company's articles and accounts. Trade registry fees are significant. Closing a business is still expensive and time consuming in Turkey. Insolvency procedures take about 3.3 years and recovery rates - at 20% on average - are very low. Progress in removing exit barriers remains weak. Foreign investors 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. Overall, market exit remains expensive and lengthy, and bankruptcy proceedings are still relatively onerous.

Legal system

A reasonably well functioning legal system, including in the area of property rights, has been in place for several years. Registering a property in Turkey requires six separate procedures and takes six days. Enforcement of commercial contracts is still a rather lengthy process, which involves 35 procedures and takes an average of 420 days. Commercial court judges do not have a very high level of specialisation, which results in lengthy court proceedings. The expert witness system still operates as a parallel judicial system, but does not improve the overall quality. Out-of-court dispute settlement mechanisms are very seldom used. The judicial system and administrative capacity can be further improved. Overall, the legal system continues to provide effective support to the business environment.

Financial sector development

Largely as a result of the major improvements made to the regulatory and supervisory framework in the aftermath of the 2001 financial crisis, the banking sector has demonstrated its resilience to the global financial crisis. Risk ratios in the financial sector remained robust. Banks continued to dominate the sector, as their share of total financial sector assets increased from 79.6% in 2009 to 80.4% in 2010. The share of the insurance sector decreased from 3.2% to 2.7% (including private pensions, whose share remained at 1.5%). With 3.6% of the total, the share of securities market intermediaries (investment companies, mutual funds, investments trusts, real estate investment trusts, venture capital funds) remained limited. Stock market capitalisation increased from 36.2% of GDP in 2009 to 41.1% of GDP in 2010.

Banking sector assets relative to GDP increased from 87.6% in 2009 to 91.2% in 2010 (excluding the Central Bank). The share of state-owned banks in total banking sector assets decreased from 30.1% in 2009 to 29.6% in 2010, while the share of domestic private banks was 49.4% and the share of foreign banks 13.5%. The planned privatisation of state-owned banks made no progress. In tandem with the recovery, financial intermediation activities accelerated due to the rapid credit expansion. Banking sector loans increased from 41.2% of GDP in 2009 to 47.6% of GDP in 2010. Corporate loans (20.7% of GDP), SME loans (11.3% of GDP) and consumer loans (15.6% of GDP) all increased their relative weight in economic activity. The increase in deposits, on the other hand, was more modest, up from 54% of GDP in 2009 to 55.8% in 2010. The value of outstanding debt instruments traded in the bond market decreased slightly, from 38.2% in April 2009 to 34.9% in 2010. Although there were more private debt issues in 2010 and 2011, these instruments accounted for only 1.3% of the total equity market as of 31 March 2011.

The efficiency of financial intermediation improved, as measured by the sector's average spread, which shrank from 5.3% in 2009 to 3.2% in late 2010. Non-performing loans as a share of total banking sector loans decreased from 5.3% in 2009 to 3.7% in 2010, returning to their pre-crisis level. Despite a slight decrease, capital adequacy in the banking sector remained well above the statutory minimum of 12%: namely at 20.5% in 2009 and 18.9% in 2010. Banking concentration can be described as moderate (just over 60% of total banking assets are with the five largest banks). Although in the first quarter of 2011 the banking sector's profits were seriously eroded by the steep rises in RRR and fell by 17% in the first quarter of 2011, the sector remained cost-effective and profitable. Overall, the financial sector has shown considerable strength thanks to earlier reforms.

5.2. 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 rapid recovery from recession, which confirms the economy's improved resilience to shocks. However, it is also fuelling a rapid expansion of the current

account deficit, presaging the return of persistent imbalances in the Turkish economy. As the recovery gets under way, an opportunity for structural reforms is being opened up in recognition of Turkey's sound fundamentals. At the same time, further growth in Turkey is being held back by the lack of activity and productivity growth that is not sufficiently broad-based. Overall, the strong recovery has not affected the functioning of market mechanisms.

Human and physical capital

The educational reform programme, which is a key component of the National Development Plan (2007-2013), is being implemented. It sets two key priorities for education, modernisation and reform: namely increase the responsiveness of education to demand and enhance the education system. In 2010, the challenges remained significant. Although there has been some progress and the top students in Turkey are performing well, the vast majority of Turkish students display the lowest proficiency levels in basic skills and problem-solving. Participation in higher education remains low by international standards. Around 45% of 20- to 24-year olds go to university, which is 8 percentage points more than five years ago. Reforms and increased spending on education are obviously generating a positive impact on educational attainment and schooling rates, but significant problems remain with regard to the quality of education.

A high level of job creation is needed to provide work opportunities for young people entering the labour market. Overall, the Turkish labour force remains to a large extent low skilled due to persistent problems in the education and vocational training systems and a segmented labour market. While employment measures for the young and for women have increased, their scope and impact is still too low.

The gross fixed capital formation ratio rose from 16.9% of GDP in 2009 to 18.7% in 2010. The increase in public investments was relatively small (from 3.7% to 3.9% of GDP), whereas private investments increased from 13.2% to 14.9% of GDP. FDI inflows to Turkey (gross) increased from €5,861 million to €6,738 million. Acquisitions of real estate by foreigners were up to 28% of total FDI inflows in 2010 (from 21% in 2009). Although the official aim of the government is to increase expenditures on research and development to the target figure of 2% of GDP by 2010, the actual outcomes remain much lower, given that R&D expenditure amounted to just 0.85% of GDP in 2009 (latest available data). Growth in gross electricity consumption has averaged around 6% in each of the past five years, and no extra power generating capacity has been built. Improvements in infrastructure have been modest. Overall, modest progress was made on upgrading the country's human and physical capital.

Sectoral and enterprise structure

Following a significant increase in 2009, agriculture's share of employment stabilised at 25% in 2010. Jobs were created in the industrial sector (including construction) and the share of agriculture in the total labour force rose to 26.3%, i.e. back to pre-crisis levels. Employment in the services sector was down from over 50% in 2009 to over 48.6% in 2010. Labour markets have been adjusting rapidly to the need for recovery, and overall employment grew by over 6% in 2010. At the same time, the relative output of agriculture remained stable at 8.4% of GDP in 2010. The contribution of industry (including construction) to GDP grew proportionally faster than that of other sectors, accounting for roughly 26% of GDP. The contribution of services decreased slightly to about 64% of GDP.

Progress in the liberalisation of the electricity and natural gas sectors has been uneven. The privatisation programme for electricity distribution assets was completed in 2010 and the process for the generation of assets has been launched. The long awaited law amending the previous law on renewables was adopted in mid-January 2011 with a view to promoting investments in renewables. There are no developments to report in the gas sector. The deadlines set by the Natural Gas Market

Law to restructure the incumbent gas monopoly holder, BOTAS, have not been met. The level of competition in the telecommunications market remained limited. The percentage of alternative operators in the broadband and fixed telephony market remains low.

Overall, the industrial sector is still the driving force behind Turkey's rapid recovery.

State influence on competitiveness

There has been some long awaited progress in the field of State aid. The law on State aid monitoring has been adopted and the State Aid Authority has become operational. It is expected that it will establish a comprehensive State aid inventory and an action plan for aligning all State aid schemes with the acquis. Competitiveness rules should also be relaxed by the Parliament's adoption of the Commercial Code, which is expected to enter into force in July 2012. Public procurement policies continued to be undermined by exceptions to the regulatory framework. Overall, the new law on State aid monitoring and the operation of the State Aid Authority may increase transparency and lead to a reduction of State aid.

Economic integration with the EU

The openness of the economy as measured by the value of exports and imports of goods and services as a percentage of GDP remained unchanged at 47.7% in both 2009 and 2010. The EU's share of Turkey's total trade decreased from 42.6% in 2009 to 41.7% in 2010. The EU share of Turkey's exports increased slightly from 46% to 46.2%, although its import share decreased from 42.6% to 41.7%. The EU continued to be the main source of FDI inflows to Turkey, with a 79% share in 2009 and a 76% share in 2010. Foreign capital investment inflows originating from the EU countries – excluding real estate and others - increased from €4,356 million to €4,723 million. The share of Northern African countries in Turkey's exports was down from 9.9% to 8.2%. Near and Middle Eastern countries increased their total share in Turkey's exports from 18.8% to 20.5% in 2010. Overall, trade and economic integration with the EU remained high.

Based on the information available on real wage developments, unit labour costs appear to have increased at a broadly similar pace to labour productivity. At the same time, pressures leading to an appreciation of the nominal exchange rate were observed in 2010. In the year to May 2011, the exchange rate for the lira appreciated by 3% in nominal terms against a basket of 50% US dollar and 50% euro. In real terms, corrected for both producer and consumer price developments, the lira strengthened by 5%. Overall, standard indicators suggest that there has been a slight worsening in Turkey's export competitiveness.

5.3. Conclusions

The economy of Turkey is currently experiencing a robust economic recovery. Public finances are improving and confidence in a lasting transformation of the country's economic prospects and stability is increasing. Nevertheless, the rapid expansion of economic activity, driven by strong domestic demand, has led to significant and rising external imbalances that pose a threat to macroeconomic stability.

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 accelerates the implementation of its comprehensive structural reform programme.

The economy expanded rapidly in 2010 and in the first half of 2011. Along with the high GDP growth, strong employment growth allowed for a decrease in unemployment. As a result of primarily higher cyclical revenues and a lower interest burden, the consolidation of public finances remained on

track. The financial sector has shown considerable strength thanks to earlier reforms while the legal system continues to function relatively well. Moreover, the new law on State aid monitoring and the operation of the regulatory authority may increase transparency and lead to a reduction of State aid. The free interplay of market forces has been confirmed. Privatisation has accelerated. The EU remains Turkey's most important trade partner and investor.

However, trade and current account deficits have been rising and external imbalances are now significant. Monetary policy has been only mildly successful in curbing credit growth, which along with high commodity prices, continues to feed Turkey's growing current account deficit. More support from the fiscal side, and some specific and targeted micro-prudential measures are being elaborated, including by the banking regulator, in order to help engineering a soft landing of the economy and ease the burden placed on monetary policy. Turkey's price and cost export competitiveness has slightly worsened. Inflation has started to rise, in large part due to pressures stemming from energy and food inputs, buoyant economic activity and hikes in administrative prices. A more resolute implementation of structural reforms is awaited. Measures to increase fiscal transparency and better anchor fiscal policy were modest, while they could help Turkey to gain credibility in the markets. Market exit remains difficult and bankruptcy proceedings are still relatively cumbersome.

6. ALBANIA

In examining economic developments in Albania, 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 February 2011, Albania submitted its fifth Economic and Fiscal Programme (EFP) covering the period 2011-2013. The key objectives remained unchanged from the previous EFP and economic policy continued to be directed towards ensuring macroeconomic stability accompanied by expenditure-led budgetary consolidation. Progress on structural reforms was limited. In the context of the still-difficult economic situation of Albania's trading partners, the economic growth projected in the programme is on the optimistic side. Despite a more polarised political landscape, there was broad agreement on the key essentials of a market economy. Overall, consensus on the fundamentals of a market-oriented economy has been maintained.

Macroeconomic stability

Economic activity posted strong growth of some 3.8% in 2010, according to provisional data. GDP growth in 2010 was mainly driven by foreign demand as exports of goods rose by 63%, spurred mostly by exports of electricity due to a rebound in energy prices combined with full-capacity production from local hydropower generation, while domestic demand remained weak. Private consumption growth decelerated to 2.2%, weighed down by weak consumer confidence, loose labour market conditions, a decline in workers' remittances and sluggish household credit. Gross fixed capital formation contracted by 5.2%, reflecting the substantial cuts in public spending as part of the government's fiscal consolidation efforts. Provisional data show that economic activity continued to expand during the first half of 2011. Real GDP grew by 3.4% year-on-year in the first quarter with construction breaking its long contraction period and recording positive growth of 4.8% year-on-year, while growth moderated in industry and services that had recorded a swift recovery in 2010. Per capita GDP in terms of purchasing power parity was estimated at 27.1% of the EU 27 average in 2009, up from 25.9% in 2008. Overall, the Albanian economy continued to grow, albeit below the previous high rates.

The current account deficit declined to 11.9% of GDP in 2010, from 15.1% in 2009, reflecting an improvement in all the components of the current account, most notably a strong recovery in exports of goods. The still large trade deficit narrowed to 23.4% of GDP in 2010, from 26.4% in 2009, in the wake of an across-the-board rise in exports. Strong increases were recorded in 2010 in energy exports, as the local hydropower generation operated at full capacity, followed by mining and construction materials. Albanian exports continued to depend heavily on the textile and footwear industries, which account for 34% of total exports, although their share is declining. Exports of mining products grew substantially in 2010 as new fields came into operation and global commodity prices recovered. Remittances were down by around 11.7% in 2010, to 7.8% of GDP, as result from weak international economic conditions in host countries. The current account deficit deteriorated in the first half of 2011, as the trade deficit widened due to the slowing down of energy exports and a 10% fall in workers' remittances.

During 2010, FDI inflows increased by 17.2%, primarily reflecting new investment in exploration and drilling for oil and gas and new concessions in the energy sector. Net FDI in the first quarter of 2011 was around one-third that registered in the corresponding period of 2010. Although FDI inflows increased year-on-year, a significant amount of foreign capital was repatriated resulting in a sharp

drop in net FDI. Portfolio investment also increased, thanks to the €300 million Eurobond issue by the government. Capital inflows declined by some 11%. Overall, the balance of payments posted a surplus in 2010 which led to a corresponding rise in reserves of some €179 million. Albania preserved a sufficient level of international reserves at around 4.8 months of imports. Overall, despite an improvement in 2010, further reducing the current account deficit remains challenging, especially if the decline in workers' remittances persists.

Table 6.1:

Albania - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	5.4	5.9	7.5	3.3	3.8	3.4*
Private consumption	Ann. % ch	7.2	13.4	9.8	7.7	2.2	N.A.
Gross fixed capital formation	Ann. % ch	16.2	6.5	12.9	2.4	-5.2	N.A.
Unemployment	%	13.9	13.4	12.8	13.8	13.7	13.4
Employment	Ann. % ch	0.2	0.2	2.9	-0.8	-4.7	2.5
Wages, public sector	Ann. % ch	7.5	17.1	8.3	11.9	6.7	7.3
Current account balance	% of GDP	-6.6	-10.5	-15.5	-15.1	-11.9	-12.0*
Direct investment (FDI, net)	% of GDP	3.5	5.9	6.9	7.7	9.4	8.1*
CPI	Ann. % ch	2.4	2.9	3.4	2.3	3.6	4.1
Interest rate (3 months)	% p.a.	5.49	5.92	6.24	N.A.	N.A.	N.A.
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate LEK/EUR	Value	122.76	123.31	122.39	131.82	137.48	140.35
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-3.3	-3.5	-5.5	-7.0	-3.0	-1.6
General government debt	% of GDP	56.8	54.8	54.8	59.0	58.0	56.1

* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment in Albania was high at 13.7% in 2010, the same as a year earlier. Private non-agriculture employment increased gradually during the year, while agriculture employment rose in the third quarter. Labour market conditions improved somewhat in the first half of 2011. Employment grew by 2.2% and 2.7% in the first and second quarters, respectively, mostly reflecting an increase in private non-agriculture sector jobs. Unemployment in the first quarter decreased to 13.5% and further to 13.3% in the second trimester. Labour market statistics continue to be weak and are distorted by a large informal sector. Overall, unemployment remains high.

The annual average inflation rate rose to 3.6% in 2010 from 2.3% in 2009, remaining within the Bank of Albania's (BoA) target range of 2-4%. The main contributors to inflation were international food and fuel prices along with higher administrated prices for water and electricity. Inflation accelerated to 4% in the first quarter of 2011 reaching a peak of 4.2% in May, before receding to 3.1% in August. The rise in inflation in the first quarter of 2011 was primarily driven by higher prices for food and, to a lesser extent, fuel, due to developments in the international commodity markets as well as increases in indirect taxes in 2011 (VAT on medicines and excise taxes). In response to rising inflationary pressures, the Bank of Albania raised the key repo rate from 5% to 5.25% in March.

The level of euroisation in Albania remains high. Foreign-denominated loans and deposits account for 67% and 47% of total stock, respectively. Although necessary for the currency's stability, such high euroisation constrains the room for manoeuvre in monetary policy and can be a source of instability in the financial system since it may expose banks to currency mismatches or indirect credit risks.

Albania continued to pursue a free-floating foreign exchange regime. The lek depreciated by 4.3% against the euro in 2010 and by a further 2.7% in August 2011. Overall, monetary policy remained sound, maintaining price stability while inflation remained within the target range.

During 2010, further progress was made in improving the tax administration in the form of both general revenue collection and administrative reforms. Electronic declaration has been made mandatory for VAT taxpayers, while the relevant legislation allows large taxpayers to file tax returns

online. In 2011, various measures have been taken to broaden the tax base, including introduction of 10% VAT on medicines, a new system of fiscal stamps on excise goods and medicines, the extension of VAT to cover professional services and addition of more products subject to excise tax. In addition, the government declared a fiscal amnesty which aims to legalise undeclared assets and income. Despite these efforts, gaps remain in both revenue collection and administrative reform. A fully-fledged tax compliance system is still lacking, law enforcement continues to be weak, while the revenue collection at local government level remains weak.

The upward trend in the fiscal imbalance in recent years was reversed in 2010, with the budget deficit falling to 3% of GDP from 7%, a year earlier. This improvement in the budget balance was primarily expenditure-led. Total expenditure stood at 29.6% of GDP, or 3.4 percentage points less than in 2009. More than four-fifths of the reduction in expenditure resulted from cuts in capital spending (by almost a third from the 2009 levels). Total revenue stood at 26.6% of GDP in 2010, 0.6 percentage points higher than the previous year. The 2011 budget envisages a fiscal deficit of 3.5% of GDP, based on assumed real GDP growth of 5.5%. The projected increase in the fiscal deficit is mainly due to the planned rise in capital outlays as the government embarks on a renewed drive to upgrade infrastructure. In the period January-July 2011, total government revenue increased by 2.3%, while total expenditure rose by almost 6% compared to the same period of the previous year. Tax revenues for this period were lower than planned, reflecting over-optimistic projections. Moreover, tax receipts underperformed primarily as a result of weak indirect tax revenue amid sluggish domestic demand. The higher government expenditure was driven mainly by an increase in current expenditure, specifically by social security spending. The government deficit in the period January-July rose by a third compared to the same period of the previous year. These developments prompted the government to re-balance the budget in July by cutting expenditure to a more affordable level of revenues, aiming to preserve the 2011 deficit at 3.5% of GDP. Tax receipts were revised downwards while expenditure was cut, mainly as result of lower capital outlays and spending on maintenance. At the same time, an increase in public service salaries and pensions was granted in July 2011.

The primary source of deficit financing in 2010 consisted of domestic borrowing while, contrary to previous years, privatisation receipts were limited. The domestic financing of the fiscal deficit affects the level of interest rates for business and consumer borrowing and diverts savings to the public sector. Albania also issued its first-ever Eurobond on the international markets for €300 million with an interest rate of 7.5% and a five-year maturity. Most of the proceeds from the Eurobond were used to pay back a syndicated loan, while the rest is expected to finance public investment. In 2010, the debt-to-GDP ratio stood at 58%, down from 59% the previous year. Albania's relatively high public debt continues to show a short-term bias which requires frequent re-financing, although some three fifths of the debt is domestic. Still, in the event of an increase in interest rates, the fiscal space would be further limited suggesting that, at such high levels, public debt remains a source of macro-financial vulnerability. Overall, the fiscal deficit has been reduced significantly, but pursuing and strengthening budgetary consolidation that ensures a lasting reduction of the public debt remains a priority.

Overall, macroeconomic stability has been maintained, as Albania weathered the lingering adverse economic conditions in the region and beyond well. Monetary policy has successfully helped to keep inflation stable. The high level of euroisation continues to limit the effectiveness of the monetary transmission channels. The relatively high public debt restricts fiscal space and remains a source of vulnerability, underlining the importance of pursuing budgetary consolidation.

Interplay of market forces

The private sector contributes 80% of GDP and around 82% of employment. State participation in the economy remains low, but progress in the planned privatisation reform stalled in 2010. No progress can be reported with the government's remaining shares in some strategic companies. Overall, State involvement in the economy is low.

Market entry and exit

Albania has made good progress with facilitating business registration and business licensing procedures. The National Licensing Centre has extended its services network to cities beyond Tirana. However, the procedures for granting building permits remain lengthy, hampering the recovery of the ailing construction sector. The e-signature system to allow online applications for registration became operational in March 2011. The Albanian Investment Development Agency, which serves as a one-stop shop for foreign investors, became operational in June 2011. The Law on foreign direct investment was amended to grant special protection, under certain conditions, to foreign investors in the event of land ownership disputes. However, the impact on foreign investment cannot be assessed, as the new legislation has not yet been applied in practice.

Some progress was achieved on bankruptcy procedures with the establishment of the Bankruptcy Supervisory Agency. However, the Agency is not yet operational. Some 130 bankruptcy declaration requests were submitted during 2010 out of which 75% were analysed and only 6 were accepted to follow the bankruptcy procedure. Overall, some progress was made to facilitate market entry. However, bankruptcy procedures remain slow.

Legal system

Although some steps were taken on legalisation of properties and registration of land ownership in coastal and urban areas, a comprehensive strategy and action plan to tackle the enduring issue of property rights has not been adopted yet. Lack of secure property rights and weak enforcement of the rule of law remain causes for concern. Moreover, the business community continues to face delays in court procedures, and weak enforcement of contracts and execution of collateral. Informal methods of contract enforcement, by-passing the legal system, continued to be widespread. Steps were taken towards establishing the private bailiff office, but training and administrative capacities remain weak. Moreover, the delay in establishing the administrative court due to lack of political consensus remains an obstacle to investment.

Progress was achieved in the area of regulatory reform and on strengthening the institutions that oversee it. In 2010, the government adopted a regulatory impact assessment (RIA) system with the aim of improving the efficiency and effectiveness of the regulatory decision-making process. Phasing-in of a simple version of RIA is scheduled to commence in 2011, after which a decision will be taken on whether to switch to a full system by 2013. The new Law on inspections was adopted in June 2011 laying the foundations for restructuring the inspectorates. Overall, weaknesses in the rule of law and widespread corruption are continuing to have a negative effect on the business environment.

Financial sector development

Albania's financial system remains dominated by the banking sector, which accounts for some 95% of the system's total assets. Despite the banks' dominance, the share of bank lending to the private sector and households was low at 38.7% of GDP in 2010, up from 37.5% a year earlier, indicating that there is still significant scope for financial intermediation. The banking sector remains well-capitalised, with the capital adequacy ratio reaching 15.4% at the end of 2010 and falling slightly to 14.8% in the second quarter of 2011, well above the legal minimum of 12% set by the BoA. The profitability of the banking sector was positive during 2010, but profitability indicators deteriorated in the first half of 2011. While provisions have been adjusted accordingly, the level of non-performing loans (NPLs) remains a concern for the banking sector. The ratio of NPLs was estimated at 13.6% of total loans at the end of 2010 and rose sizeably to 16.6% in the second quarter of 2011.

The concerns over the worsening quality of the loan portfolio and subdued domestic demand kept banks from expanding lending. Credit growth slowed to 8.6% in 2010, down from 20.5% a year

earlier. The private sector's loan portfolio grew at a more appropriate 10.6% in 2010 and was mostly directed to businesses, whilst household loans remained almost unchanged from 2009. Lending growth increased slightly in the first half of 2011 and stood at 12.5% in July. The interest rates charged by commercial banks on business and consumer loans continued to be driven by the interest paid on government securities. Following sharp withdrawals in 2009, deposit growth resumed during 2010, averaging 15.5% for the whole year as public confidence in the banking system was gradually restored, especially in the second half of the year. In the first half of 2011, deposit growth stood at approximately 15.8%, year-on-year. External borrowing by the banking sector reached 4.9% by the end of 2010 and rose to 6.4% by July 2011. The average yield of 12-month Treasury bills stood at 7.2% at the end of 2010, down from 9.2% a year before, and increased to 7.7% by August 2011.

The Bank of Albania's periodic stress tests show that the direct exchange rate risk made some moderate impact due to the low open foreign-exchange position of the banking sector. With respect to liquidity risks, the banking sector appears to have a very good liquidity situation for operations in the national currency, whereas operations in euro call for constant monitoring. Overall, the banking sector remains well-capitalised and liquid. However, the high level of non-performing loans is a cause for concern.

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

Existence of a functioning market economy

Macroeconomic stability was maintained. GDP growth accelerated, but remained below historical averages. Inflation expectations remained anchored and the government deficit was brought down. However, public debt remains relatively high. The planned privatisation programme was delayed, the pace of reforms to facilitate market entry and exit slowed and weaknesses in the rule of law, particularly in contract enforcement and property rights, persist. Structural imbalances in the labour market and the external account remain high. Overall, although some progress was made in establishing a functioning market economy, Albania needs to commit itself to further structural reforms, amongst other things by bolstering economic policy governance, enhancing labour market performance and protecting property rights.

Human and physical capital

During 2010, the budget expenditure on education was estimated at roughly 3.4% of GDP. The budgetary allocation for 2011 is projected at 3% of GDP. Spending on education during 2011 will aim to improve the overall quality of service delivery at all levels of education and training with a particular focus on information technology and better matching of vocational education with market demand. Public spending on research and development accounts for 0.05% of GDP in the 2011 budget. Despite the government's efforts to consider education and health among its priority sectors, shortages of qualified employees persist, as a result of deficiencies in the education and skills system. ICT was added to the curricula for 17 vocational education and training schools. Some progress was achieved by the National Employment Service in improving the information system on job vacancies. The brain gain instrument which granted bonuses to public officials graduated abroad was suspended due to budget cuts in July 2011.

Investment stood at 36.8% of GDP in 2009, slightly lower than the 38.2% in 2008. Expressed as a percentage of GDP, private-sector investment reached 27.2%. FDI inflows are estimated to have increased by about 17% in 2010, to an estimated 8.8% of GDP, reflecting higher investment, mostly in the hydrocarbons sector. Public investment was directed primarily at road infrastructure. Construction of a new stretch of road between Tirana and Elbasan started at an estimated cost of about €270 million, financed mainly by soft loans from international financial institutions (IFIs). Rail transport remains underdeveloped. Further investment in improving the infrastructure and logistics

will be needed in order to attract investors and stimulate tourism. Insufficient road maintenance and illegal construction along roads remain causes for concern. In the energy sector, a number of concession agreements for construction and operation of hydroelectricity generation plants were approved, and distribution losses have been slightly reduced overall. However, bill collection rates remain low at around 77%. Overall, spending on human and physical capital has increased. However, further investment will need to be committed to improve the competitiveness of the economy.

Sectoral and enterprise structure

The relative shares of agriculture, industry and services remained broadly unchanged in 2010 from previous years, with slightly less than three fifths of Albania's GDP generated by the services sector. Agriculture accounted for some 19% of output, but remains the largest employer with 55% of total employment in the second quarter of 2011. The share of construction fell to 11% in 2010 from 14.4% in 2009, while industry's share increased to 11% in 2010 from 9.5% a year earlier. Inward processing performed well during 2010 increasing its exports as compared with 2009.

Weak tax and expenditure policies and poor law enforcement, including the fight against corruption, have been fuelling a sizeable informal sector. Some steps were taken during the year to address informality, amongst other things by requiring large taxpayers to declare taxes online and proceeding with installing cash registers. However, since only around half of the companies have installed the devices, the take-up rate remains low. SMEs continue to obtain financing from a credit support scheme financed by the Italian government. By December 2010, 49 businesses had benefited from approximately €1 million under the scheme. An agreement signed in April 2011 between the Albanian government and six commercial banks will facilitate access to a €2.5 million credit guarantee scheme for businesses. Since November 2010, five new additional micro-credit institutions have been included in the credit registry.

Concerning network industries, the high rate of losses in the electricity distribution system remains a persistent challenge to electricity supply. The second third-generation (3G) licence in the telecommunications sector was sold in September 2011. The fourth mobile telecommunications company started operating during 2010. Prices in this sector are set by the regulatory body and a revised tariff reduction scheme entered into force in March 2011, aiming to regulate the market price. Overall, there were no major changes in the structure of the economy. While some measures were taken to combat the sizeable informal sector, informality remains a challenge.

State influence on competitiveness

Subsidies in 2010 are estimated to have declined to 0.3% of GDP from 0.4% in 2009. While there is no specific financial assistance for companies, subsidies are granted to a limited number of sectors, namely railways and water supply. State aid granted to the energy sector has declined since 2009. Overall, State intervention remains limited.

Economic integration with the EU

The openness of the Albanian economy continued to increase. The sum of imports and exports of goods and services stood at slightly more than 86% of GDP in 2010, up from 82% in 2009. Total foreign trade in goods and services rose by 12% in 2010 compared with 1.5% in 2009. Both imports (7%) and exports (21%) of goods and services grew at a faster pace than in 2009. The EU remains Albania's leading trading partner accounting for around three-quarters of both exports and imports in 2010, with the combined share of Italy and Greece amounting to 70% of total merchandise trade by volume. Overall, the EU remained Albania's leading trading and investment partner in 2010. Trade with CEFTA countries increased. However, Albania's production base is concentrated around just a few low value-added sectors and export markets, leaving the economy vulnerable to specific shocks.

6.3. Conclusions

The economy of Albania maintained macroeconomic stability and positive growth during and in the aftermath of the global crisis. However, the political stalemate hampered the capacity of the government to implement necessary structural reforms. The economy grew by 3.8% in 2010, thanks to exports, while domestic demand was muted. Monetary policy has successfully assisted in keeping inflation stable, also against heightened international commodity prices. Shortcomings regarding the enforceability of contracts and the rule of law, together with weak infrastructure and human capital and the informal economy continue to hinder economic development.

As regards the economic criteria, Albania made some progress towards becoming a functioning market economy by reducing the fiscal and external deficits and keeping inflation expectations anchored thereby reinforcing macroeconomic stability. Albania should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it steps-up structural reforms, including by reinforcing the legal system and strengthening physical and human capital.

Despite a more polarised political landscape, a broad agreement on the key essentials of a market economy was maintained. The Albanian economy continued to grow, albeit at a slower pace and notwithstanding the weak economic conditions in important trading partners. Monetary policy remained sound, maintaining price stability while inflation stayed within the target range. The current account deficit and the fiscal imbalance declined in 2010. State involvement in the economy is low and subsidies remain limited. The banking sector remains well-capitalised and liquid. Some progress was made to further facilitate market entry. The EU continues to be Albania's main trade and investment partner.

However, a lasting reduction of the relatively high public debt has not been achieved. Further narrowing of the external imbalances may prove challenging especially if the decline in workers' remittances persists. Labour market performance deteriorated in 2010, while unemployment remains high. Implementation of bankruptcy procedures remains incomplete, while the weak rule of law hampers the enforceability of contracts and the business environment in general. The issue of property rights remains unaddressed. The high level of non-performing loans in the banking system continues to be an issue of concern. Investment in human capital and infrastructure remain inadequate. The informal sector remains a challenge. The concentration of the production in terms of sectors and export markets leaves the economy vulnerable to external shocks.

7. 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.

7.1. The existence of a functioning market economy

Economic policy essentials

Difficulties with forming governments at State and Federation levels after the general elections in October 2010 and the failure of the Fiscal Council to adopt the Global Framework for Fiscal Policies for 2011-13 had a bearing on economic and fiscal policy. In a situation of increased uncertainty over the short- and medium-term path of fiscal policy, the authorities submitted their fifth Economic and Fiscal Programme for 2011-13 in January 2011. The programme is thus fragmented and does not reflect 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 performance under the International Monetary Fund (IMF) Stand-By Arrangement remained broadly satisfactory until October 2010 when the IMF Board approved the second and third reviews. However, due to the difficulty of forming a government at State-level, further programme discussions were delayed. The first World Bank Development Loan was disbursed in October 2010. Overall, the consensus on economic and fiscal policy essentials has weakened.

Macroeconomic stability

After the recession in 2009 with a drop in real GDP of 2.9%, the country moderately recovered in 2010. It recorded a positive real growth rate of 0.7%, driven by external demand. Domestic demand picked up, supported by a relatively stable inflow of remittances. Industrial production increased slightly in 2010 led by export-oriented industries, but unemployment remained very high. Per capita income, measured in purchasing power standards (PPS), fell to 30% of the EU-27 average in 2010 from 31% in 2009. As a result of fiscal adjustment measures implemented under the IMF programme and increased revenues, the budgetary situation eased. Due to improvements in the trade and current account deficits and the comfortable level of foreign reserves, the external financing needs decreased in 2010. The indicators available for 2011 suggest that the economic recovery is gaining strength as industrial production increased by 8.1% year-on-year in the first seven months of the year. Overall, the economy is slowly gaining steam after the 2009 recession, but the recovery is fragile.

The current account deficit fell further from 6.2% of GDP in 2009 to 5.6% in 2010. The trade deficit fell by 4.8%, shrinking from 27.8% of GDP in 2009 to 25.9% in 2010, which contributed to the improvement of the current account. Exports rose by 27.7% nominally, and imports by 10.2%. Surpluses in the services and income accounts decreased by 8.6% and 23.2%, respectively, while that of the current transfer account increased by 3.1%, supported by the relatively stable flow of remittances. The current account deficit was financed mainly by new loans from abroad. However, the trend of an improving trade balance was reversed in the second half of 2010 when the nominal increase of imports exceeded that of exports. This deterioration continued in the first half of 2011 when the trade gap increased by 18.3% year-on-year. Imports and exports increased both by 18.3%, mining and manufacturing being the main sectors recording export growth. Bosnia and Herzegovina's external public debt increased by 20.2% in 2010, from 21.8% of GDP in 2009 to 25.7% in 2010, mainly due to the disbursements made in the context of the IMF and World Bank programmes. In the first half of 2011, the external public debt decreased slightly by 1.5%. Public international creditors account for 89% of the country's external public debt. The largest creditor remains the World Bank group. Official foreign exchange reserves decreased by 5.7% in the first half of 2011 from end-2010, though still covering around five months of imports. Overall, external imbalances have slowly started

to rise after the sharp contraction experienced in 2009 and the first half of 2010, although the current account deficit is still much lower than before the crisis.

Table 7.1:

Bosnia and Herzegovina - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	6.0	6.2	5.7	-2.9	0.7	N.A.
Private consumption	Ann. % ch	4.5	10.9	10.3	2.3	-0.9	N.A.
Gross fixed capital formation	Ann. % ch	-9.7	34.3	22.8	-17.7	-9.9	N.A.
Unemployment	%	44.2	42.9	40.6	42.7	42.7	43.1
Employment	Ann. % ch	2.3	4.4	2.7	-2.8	1.9	1.0
Wages	Ann. % ch	9.6	9.8	16.6	8.2	1.8	4.5
Current account balance	% of GDP	-8.0	-10.7	-14.0	-6.2	-5.6	-7.7
Direct investment (FDI, net)	% of GDP	6.2	13.5	5.3	1.4	0.4	1.7
CPI	Ann. % ch	6.1	1.5	7.4	-0.4	2.1	3.9*
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	N.A.	4,330	2,251	1,038	954	1,056
Exchange rate BAM/EUR	Value	1.95	1.94	1.94	1.94	1.93	1.93
Nominal eff. exchange rate	Index	99.7	100.3	100.1	96.3	96.5	96.1**
General government balance	% of GDP	2.9	1.2	-2.2	-4.5	-2.5	N.A.
General government debt	% of GDP	21.1	18.2	17.2	21.8	25.7	25.0

* July

** Q1

Sources: Thomson Reuters/Ecowin, Eurostat

The average unemployment rate in 2010 stood at a very high 27.2%. Registered unemployment reached 43.1% in June 2011, while according to the Labour Force Survey (LFS) following the International Labour Organisation (ILO) methodology conducted annually in April/May, unemployment increased to 27.6 % in 2011 from 27.2% in 2010. It was particularly high among the young population (57.9% for people aged between 15 and 24, according to the LFS). In the first half of 2011 the highest year-on-year growth in employment was registered in education, real estate and health, while employment fell in agriculture, mining and manufacturing industries, as well as in trade and construction. Despite the already large size of the public sector in Bosnia and Herzegovina, the number of employees in the public administration increased further, by 2.1% year-on-year in the first six months of 2011. Average monthly nominal gross wages increased by 1.8% in 2010 and remained relatively stable in the first seven months of 2011. Structural rigidities such as the high rates of social contributions, poorly targeted social transfers and low labour mobility, are continuing to hamper job creation and the propensity to work. Overall, labour market conditions remained poor and were not supported by the weak growth dynamics.

Annual inflation reached 2.1% in 2010, up from -0.4% in 2009. The inflationary trend was mainly driven by the rise in food and transport prices towards the end of the year. Inflation continued to rise in the first seven months of 2011, reaching 3.9% in July, pushing the 12-month moving average inflation rate up to 3.1%. The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the anchor currency, enjoying a high level of confidence and credibility. Monetary policy settings remained unchanged throughout 2010. As of February 2011 the minimum reserve requirement for short-term deposits was lowered from 14% to 10%. Nevertheless, the banking system's reserves with the Central Bank remain significantly above the minimum required level. The M2 monetary aggregate increased by 6% year-on-year in July. Overall, monetary and financial stability have been preserved while inflation is picking up.

The fiscal performance in 2010 benefitted from the recovering economic activity, which resulted in increasing revenues, and from the adjustment measures implemented under the IMF programme. The consolidated budget deficit fell to 2.5% of GDP, which is well below the 2009 outcome of 4.5%. However, the share of general government in GDP remains high, with 2010 revenues at 44.4% of GDP. Adjustment measures on the expenditure side included cuts in wages and benefits in the public sector, which resulted in only a marginal 0.5% rise of the consolidated wage bill in nominal terms. Consolidated revenues increased by 5% in 2010. 44% of the revenues originated from indirect taxes

which increased by 6.7%, driven by the recovering economic activity, the development of imports and import prices and the increase of excise duties on tobacco and oil derivatives which counteracted the continuous reduction of duties and tariffs as set out in the Interim Agreement on trade, in force since mid-2008. Expenses increased by 1.6% year-on-year in 2010. Current spending dominates the budget with wages accounting for 29.2% of overall expenditure and subsidies and transfers (mainly social benefits) for 39.2%. The balance of the collected social contributions against the paid out social benefits returned on the positive side due to the simultaneous rise of the contributions and drop of the benefits. The flat income tax rate in Republika Srpska was raised from 8% to 10% as of 2011 and the non-taxable income threshold was abolished. Following amendments to the Law on Social Contributions in Republika Srpska, the overall social contribution rate increased from 30.6% to 33% of the gross salary as of January 2011. Excise duties on tobacco were raised as of 2011.

Budget planning for 2011 and beyond, as well as the sustainability and credibility of fiscal policy in Bosnia and Herzegovina, were seriously hampered by the non-adoption of the Global Framework for Fiscal Policies for the periods 2011-2013 and 2012-2014. The Parliament of Republika Srpska adopted the Entity's 2011 budget in December 2010. It planned the same nominal expenditure as the budget for 2010. In the Federation, a temporary budget was in place in the first quarter. The Federation 2011 budget was adopted in March and showed a total amount of expenditure planned 9% lower than in 2010, with high uncertainties surrounding its financing. At the State-level, temporary budgets were in place during the first three quarters of 2011. The 2011 State-level budget was adopted by the Presidency in April, showing an increase in volume by 2% compared to 2010. However, it remains to be adopted by the Parliament. All budgets were established in the absence of a medium-term budgetary strategy. The Federation revised in July its 2011 budget to allow for some increase of specific social benefits, partly compensated by cuts in investment and the wage bill. Republika Srpska is planning to rebalance its 2011 budget in October. In May 2011, the distribution coefficients for the allocation of indirect revenues from the Single Account of the Indirect Taxation Authority were corrected for the first time since 2008. The share for the Federation was lowered slightly from 64.39% to 63.98% in the benefit of Republika Srpska's share which went up slightly from 32.06% to 32.47%. The share for Brcko District remained at 3.55%. The shares are based on final consumption data. Overall, the reliability and predictability of fiscal policy in Bosnia and Herzegovina suffered from the failure to agree on Global Fiscal Frameworks which is a serious obstacle for medium-term budgetary planning and sustainability.

General government debt, both domestic and foreign, stood at 38.8% of GDP in 2010, up from 34.5% in 2009. External debt accounts for 25.7% of GDP and domestic debt for 13.1%. Domestic public debt is managed and served by the Entities (49.5% Federation, 49% Republika Srpska, 1.5% Brcko District). Verification of claims related to old foreign currency savings has advanced. Both Republika Srpska and the Federation continued issuing bonds in 2010 and 2011 to service the debt. In addition, Republika Srpska issued for the first time short-term T-bills in May and June 2011 serving as temporary financing to Republika Srpska cash-based budget deficit. The offers were met by high demand and achieved relatively favourable conditions. Overall, even though the debt-to-GDP ratio is still relatively moderate, its upward trend needs to be monitored carefully.

Although there is evidence of an ongoing trend of economic recovery, the incomplete reform process acts as an impediment to laying the foundations for solid and more domestic-driven growth in Bosnia and Herzegovina. The growing trade gap and increasing current account deficit suggest that external imbalances are again taking shape. The productive capacity and competitiveness of the economy remain weak, as domestic sources of growth are not adequately exploited and national savings remain low. The currency board arrangement enjoys a high level of confidence and credibility, while the failure to agree on a Global Framework for Fiscal Policies for 2011-2013 and 2012-2014 severely threatens the transparency, reliability and sustainability of public finances and is a serious impediment for short- and medium-term budgetary and general economic planning. Overall, the worsening quality

of budgetary processes is putting a strain on the viability of macroeconomic policies, even though 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 2010. In Republika Srpska there has been no further progress in the privatisation agenda. Following a government decision not to initiate their privatisation, strategic companies such as the power utility, Banja Luka airport and the postal company remain public. Around 69% of the initial stock of State-owned capital intended for privatisation had been sold by September 2011, unchanged from a year earlier. In the Federation, only one out of nine companies included in the revised privatisation plan has been partly privatised by stock exchange transactions with the achieved price being less than half of the company's estimated value. Attempts to privatise the remaining eight companies were unsuccessful, in some cases in spite of repeated offerings. None of the companies considered "strategic" such as the power utility and a tobacco factory were subject to privatisation. The planned restructuring and liquidation of socially-owned enterprises has made slow progress. Most prices are liberalised, even though a number of administered prices remain (e.g. for utilities, including electricity and gas). Overall, the planned privatisation process did not advance for the third consecutive year.

Market entry and exit

Following the economic crisis, the number of newly registered companies dropped by around 50% in 2010. Property registration procedures were significantly shortened during 2010 in some courts, for example from 84 to 33 days in the Sarajevo Court. The time needed to start a business was reduced from 60 to 55 days, on average, over 2010. Court registration timelines and costs are harmonised between the Entities, including the notary fees. However, the process for obtaining all the necessary documents and permits remains lengthy and companies must still register in both Entities if they want to do business in the whole country. Under the second stage of the "legislative guillotine" project in the Federation, seven bylaws have been adopted in various ministries to streamline 109 business-related administrative procedures, and some administrative improvements have also been implemented at Canton and municipal levels. Labour tax procedures have been streamlined. Overall, some improvements can be reported, particularly in registration procedures.

The legal system

The legal system in Bosnia and Herzegovina remains complex. Even though the standard of legislation is relatively high in some areas, implementation and application of laws in practice is often poor due to the weak enforcement capacity of key institutions. The average time to resolve a dispute before court in order to enforce a contract remains high at 595 days. The rule of law is weak and the judicial system often does not function efficiently, is subject to obstruction by the parties and does not cover commercial activities adequately. Overall, weak rule of law, corruption and unreliable contract enforcement continue to hamper the business environment.

Financial sector development

The financial sector is dominated by banks that are engaged mainly in traditional credit and savings activities. The share of claims on the private sector in relation to GDP decreased to around 55% in early 2011, from 58% a year earlier. Twenty-nine banks are operating in the country, one less than in the previous year as one bank in the Federation is undergoing a liquidation procedure. Two banks are under provisional administration. Twenty-one banks are under foreign ownership, seven under domestic private ownership and one is majority State-owned. Despite losing some 2.4% of their share, the five largest still account for more than half of the total assets of the banking sector. Banks with foreign ownership accounted for approximately 90% of the total banking system assets in 2010.

Banking sector assets remained relatively stable between the third quarter of 2010 and the second quarter of 2011. The capital adequacy ratio decreased slightly from 15.6% in the third quarter of 2010 to 15.5% in the second quarter of 2011, comfortably above the legal minimum of 12%, which itself is significantly higher than the 8% required in the Basel II Accord.

After an aggregate net profit of some €12.6 million in 2009, the banking sector finished 2010 with an aggregate net loss of €63.6 million. The quality of the loan portfolio continued to deteriorate. The share of non-performing loans to total loans reached 11.8% in the second quarter of 2011, the highest level since 2001, up from 9.2% in the third quarter of 2010, while the volume of loans increased. Nevertheless, banking profitability indicators showed a remarkable upward trend in the second quarter of 2011. The return on average equity increased from -3.5% in the third quarter of 2010 to 3.5%, while the return on average assets rose from -0.4% to 0.4%. Liquidity indicators deteriorated slightly during the same period with the rates of liquid to total assets falling from 29.3% to 26.2% and of liquid assets to short-term financial liabilities from 50.3% to 46.2%. Twenty-five banks are participating in the deposit guarantee scheme. Its coverage level remained unchanged at around €18,000. In March 2011, Republika Srpska amended the Law on the Banking Agency, establishing a banking system ombudsman and widening the Agency's responsibilities for supervision and protection against money laundering and financing of terrorism. The amendment also assigns the Agency customer protection functions. Overall, despite the increasing non-performing loan ratio, financial stability was safeguarded.

Annual credit growth continued its upward trend and reached 6.7% in July 2011, though from a low base. Loans to households grew slightly by 2.8%, while those to private enterprises increased by 7.7%. The recovery of deposits has lost pace in an annual comparison, growing by 2.2% in July. Households remained the main contributors to this development, increasing their savings by 10.7%, while the corporate sector reduced its deposits by 6.6%. As a consequence of these developments, the loans-to-deposits ratio climbed from 113.5% in October 2010 to 120% in July 2011. The spread between average loan and deposit interest rates of commercial banks decreased by 18 base points in the fourth quarter of 2010 compared to the previous quarter, reaching 7.87 percentage points, mainly due to reduced lending rates. This level points to still high intermediation costs. Overall, after the sharp correction experienced during the financial and economic crisis, credit activities are gaining strength again.

In the first half of 2011, local stock markets regained some previously lost ground, recording an upswing of 4% and 7.2% for the main indices of the Sarajevo and the Banja Luka stock exchanges, respectively. Their combined market capitalisation recovered somewhat to around 47% of GDP in the first seven months of 2011, up from 44% in mid-2010. The cumulative turnover almost doubled year-on-year in January-July 2011, mainly influenced by two T-bills issues of Republika Srpska (May-June 2011). The insurance sector remained small and relatively weak, accounting for 1.9% of GDP in 2010, representing marginal increase. The annual growth of premiums picked up slightly to 2.9%, as compared to 1.4% annual rise in 2009. The market was dominated by the non-life insurance segment, which accounted for 84.2% of the total. The number of companies active on the market decreased to 25 at the end of 2010, after the Federation's Insurance Supervisory Agency revoked the licence of Hercegovina Osiguranje. Overall, financial intermediation by the non-banking sector remained shallow.

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

Existence of a functioning market economy

External imbalances have been increasing and fiscal imbalances remain high, even though adjustment measures made under the international support programmes contributed to some fiscal consolidation. The failure to adopt the Global Framework for Fiscal Policies for 2011-2013 and the delays in

forming governments at State and Federation levels weakened not only the soundness, transparency, sustainability and reliability of public finances and of economic policies, but also the planning and decision-making of economic agents. The sluggish progress in the reform of the social benefits system, the still slow pace of economic restructuring, especially in the Federation, prevailing obstacles to private sector development and the composition of budgetary expenditures, increasingly dominated by current spending, at the expense of growth-enhancing activities, continue to undermine a more growth-oriented allocation of resources and a strengthening of domestic sources of growth. Unemployment remains very high. Progress towards creating a single economic space within the country has been limited. Overall, the functioning of market mechanisms remained hampered by distortions, the excessive role of the State and lack of competition, not allowing efficient allocation of resources.

Human and physical capital

Progress in the field of education and training has been limited. The Council of Ministers adopted the concept of the Qualifications Framework (Baseline Qualifications Framework) in Bosnia and Herzegovina. However, the mismatch between the qualification needs of the labour market and the profile and number of graduates coming out of the vocational and educational training system adds to other structural weaknesses, such as low labour mobility, and remains a concern. Cooperation between the education sector and employers is still weak and information on human capital endowment remains scarce. Overall, the proper functioning of the labour market continues to be hampered by structural rigidities and the weak performance of the education and training system.

Activities to improve the railway infrastructure in pan-European corridor Vc progressed during 2010. The Railways Regulatory Body introduced a set of regulations in compliance with the EU railway directives. Maintenance and upgrading of roads continued, but progress was slow, as some of the construction planned did not take place due to financial difficulties on the part of some of the contractors. Both Republika Srpska and the Federation governments terminated contracts with Slovenian companies at end-2010 after several months of inactivity on important highway projects. Net foreign direct investment (FDI) flows dropped further by more than 70% in 2010, falling to a mere 0.4% of GDP. Outflows were recorded in financial intermediation and wholesale trade, while the manufacturing sector was the main source of inflows. FDI outflows were nevertheless reversed in the third quarter of 2010 and there are indications that net FDI was slowly recovering in the first half of 2011. Overall, in an admittedly difficult market environment, domestic and foreign investors became more hesitant. Infrastructure improved slightly, but continues to require repairs and modernisation.

Sector and enterprise structure

Electricity and gas utilities continue to be public stock companies. 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. Progress towards a competitive telecommunications market has been limited. The incumbent operators continue to act as de facto monopolies in their fixed-line market segments and as oligopolies in the mobile segment. The incumbent operators published their reference unbundling offers, however, and four contracts were signed with alternative operators over the last two years. New licences were granted for Internet services and network operators. The level of broadband Internet access has increased. Overall, little progress was achieved on the liberalisation of network industries.

Due to the impact of the economic crisis, the sector structure of the economy continued to experience a shift towards an increase in services in 2010, and industrial production improved slightly. Services accounted for 67.7% of gross value added, industry and construction for 27% and agriculture for 8.6%. The traditionally high share of public administration, education and health declined slightly to

22.8%. The large informal sector, which is fuelled by weaknesses in tax and expenditure policies and in law enforcement, including the fight against corruption, is an important challenge. Overall, there have been no major changes in the structure of the economy. The informal sector remains an important challenge.

State influence on competitiveness

Direct budget subsidies to industry and agriculture remained at 1.7% of GDP in 2010. Indirect subsidies continue to be sizeable. In Republika Srpska, for example, the government approved a loan to Banja Luka airport in March 2011. Bosnia and Herzegovina has not established a State aid authority as required by Article 36 of the Interim Agreement, an obligation due for more than a year. Overall, State influence over competitiveness remains high.

Economic integration with the EU

Bosnia and Herzegovina remains an open economy. Total trade (the sum of the volume of exports and imports) increased to 85.5% of GDP in 2010, after a drop to 75.3% in 2009. The EU continues to be the country's largest trading partner, with shares of 56.5% of total exports and 45.6% of total imports in the first seven months of 2011 (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 33.2% of exports and 24.9% of imports. In 2010, the real effective exchange rate based on the country's 20 largest trading partners appreciated by 1%. Overall, the level of trade integration with the EU remained high.

7.3. Conclusions

The economy of Bosnia and Herzegovina gained some speed in 2011 after a modest growth in 2010. The recovery is nevertheless still subdued and mainly driven by external demand. Unemployment remained at very high levels. The fiscal situation eased somewhat as a result of fiscal adjustment measures implemented under the programme of the International Monetary Fund and increased revenues. However, medium-term fiscal sustainability was severely hampered by the failure to adopt the Global Framework for Fiscal Policies 2011-2013. The commitment to structural reforms and sound public finances remained weak and uneven across the country, and the quality of public finances remained low.

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 to enable the country to cope over the long term with competitive pressure and market forces within the Union.

The recovery is mainly driven by external demand, but domestic demand also picked up, supported by resuming credit activities. Industrial production is growing. Trade activities significantly increased and the level of trade integration with the EU remained high. Financial and monetary stability was preserved. The currency board arrangement continued to enjoy a high degree of credibility. Some improvements in the business environment can be reported with regard to business registration and the streamlining of administrative procedures in general.

However, the failure to adopt the Global Framework for Fiscal Policies 2011-2013 severely hampered the sustainability and credibility of fiscal policy in Bosnia and Herzegovina and left fiscal authorities without an agreement on the general fiscal line. The political stalemate in the country resulted in a significant delay of the 2011 State-level budget adoption and postponement of further programme discussions with the International Monetary Fund on the implementation of the Stand-By Arrangement. The quality of public finances remained low with high shares of current expenditures to GDP. External imbalances, in particular the current account deficit, have been rising and inflation

picked up. The business environment continued to be affected by administrative inefficiencies and the weak rule of law. Planned privatisation, restructuring of public enterprises and the liberalisation of network industries did not advance. 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, poorly targeted social transfers and low labour mobility continue to hamper job creation. Unemployment continued to be very high and the informal sector remains an important challenge.

8. SERBIA

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 interlinked. A functioning market economy will cope better 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 Serbia fulfils the two economic criteria established by the Copenhagen European Council.

8.1. Economic developments

Serbia is a relatively small economy with a population of approximately 7.3 million, living on a territory of around 77,500 square kilometres. The country is endowed with fertile arable land and natural mineral resources, including one of Europe's largest reserves of copper and up to one tenth of the world's stock of antimony. It has significant coal resources and the potential for hydroelectric-power generation.

Serbia's gross domestic product (GDP) at current prices was close to €30 billion in 2010, accounting for 0.25% of EU-27's GDP. GDP per capita in purchasing power parity (PPP) terms was 35% of the EU-27 average. The regional disparities in income are very high, with a difference of 1:10 between the capital and certain municipalities in the south.

Macroeconomic background

Serbia was the largest constituent of the Socialist Federal Republic of Yugoslavia in terms of surface and population. It was a medium developed republic. In the wake of the break-up of the former Yugoslavia in 1991, when moves had already been made towards liberalisation and the development of private sector, Serbia began the transition period with higher living standards than many other transition economies. However, the result of the loss of its traditional markets and the breakup of the existing supply chains as well as the imposition of international sanctions, against a backdrop of regional conflicts, was a severe recession. Poor economic governance, which reversed many market-oriented reforms from the 1980s, devastated the production capacity of the economy. Workers stayed formally employed, but were de facto on long-term leave. The informal economy became widespread. During 1992 and early 1994, one of the highest levels of hyperinflation in history paralysed the banking system and undermined the economic activity. In spite of a monetary reform in 1994, which partly stabilized the new dinar, the Deutsche Mark acted as a parallel currency throughout the 1990s. In 2000, GDP was less than half of its 1989 level, while other central and eastern European countries were making significant progress on the path of transition.

The economic imbalances began to slowly subside as Serbia re-launched the transition process as part of the democratic changes in 2000. The reforms included an overhaul of the institutional framework, liberalisation of the trade regime and privatisation as well as adjusting economic policies to a market economy. Starting from a very low base, Serbian real GDP rose steadily during the period 2001-2008 at an average yearly rate of around 4.5%, reaching a peak of 9.3% in 2004. Growth was lent impetus by the initiation of the privatisation process, which attracted foreign direct investment, and by the rebuilding of confidence in the banking system.

The National Bank of Serbia (NBS) put in place adequate prudential mechanisms and, together with the government, consolidated the banking sector, which led to the closure of four major state-owned banks and the subsequent establishment of new banks with fresh capital. Against the background of tight monetary policy, inflation gradually subsided, but in regional terms it remained high – at two-digit levels. In 2006, the NBS declared price stability to be its main policy objective and to that end started pursuing inflation targeting.

Post-2000 reforms were also geared towards establishing a comprehensive, transparent and accountable public finance management system. A set of new tax laws was introduced with the aim of modernising the tax administration and improving tax collection. In particular, the replacement of the sales tax by VAT in 2005 boosted tax revenues. Large budgetary deficits, which were mainly funded by the International Financial Institutions, began to decline in step with favourable economic conditions, and the deficits turned into a surplus in 2005.

On the other hand, economic growth that was largely fuelled by domestic demand weighed on Serbia's external balance. As imports rallied, the trade gap continued to widen, driving the current account deficit to over 20% of GDP by 2008. Given the large gap between domestic investment and savings, the private sector increasingly resorted to borrowing abroad, which led to a rapid rise in Serbia's foreign indebtedness.

One of the main concerns was also the weak labour market. The restructuring of companies after 2000, which involved rationalisation or closure of facilities, resulted in massive layoffs. Low labour activity, with the employment rate barely reaching 50%, became entrenched, as insufficient effort was made to remove labour market rigidities and improve the business environment.

The dependence of growth on foreign financial resources and a number of unresolved structural shortcomings exposed Serbia's economy to adverse spill-overs of the global crisis in 2009. Macroeconomic stability has been broadly preserved thanks to the implementation of an economic recovery programme agreed with the IMF under a Stand-by Arrangement (SBA). With further support from the EU and other International Financial Institutions, including the World Bank and EBRD, Serbia avoided a financial meltdown. However, the recession that followed a severe contraction of manufacturing and construction activities, in particular, substantially eroded public finances and led to a deterioration in living standards. With around 400,000 jobs lost, an unemployment rate of above 20% and the poverty rate rising above 9% in the aftermath of the 2009 crisis, Serbia's economy is faced with the need to tackle urgently a number of acute weaknesses if it is to withstand the competitive pressures.

Structural change

Serbia began the transition process in the early 1990's as an industrialised economy. The manufacturing sector, which included a productive automotive industry, collapsed as a consequence of the trade shocks related to the dismantling of the former Yugoslav markets and the international embargo, the war-inflicted damage to infrastructure and the mismanagement of public assets. After 2000, the economic revival was mainly based on services, which now account for almost two thirds of Serbia's output. While agriculture has seen its share of GDP halve to around 10%, the share of industry fell more gradually to less than a quarter. Given the prevalence of mostly unskilled labour- and capital-intensive sectors at the low-end of the production chain the export base remains shallow, limiting the share of exports in GDP to only about 30%. Yet Serbia has been increasingly reorienting its exports towards the EU markets, which accounted for around 56 % of total exports in 2010.

Since 2001, a liberalisation of trade and prices has been underway but the process has been occasionally challenged by state interference in dealing with market disturbances. The system of

administered prices has allowed the state and local authorities to control prices of all major utilities, which are often below cost-recovery levels.

Another privatisation process was initiated in 2002 which covered some 500 state enterprises (excluding public enterprises and banks which were considered strategic) and around 2,500 socially owned companies. While in the 1990s, insider shares were distributed among the employees, in the second stage the sale of assets was carried out by public auction and tender procedures. However, the process has been slow and, with the 2009 crisis, it has lost momentum or even gone backwards as a result of the repeal of numerous sale contracts on the grounds of breach of contract obligations. The share of the private sector remains low, at around 60% of GDP. Progress in the restructuring of enterprises, including the development of modern corporate governance, and the improvements of the regulatory framework were also limited.

The banking sector underwent major structural changes in the period 2000-2005. The number of banks was halved as a result of mergers and acquisitions and revoked licences to insolvent and illiquid banks. Further consolidation and privatisation attracted international private banks, which currently hold around three quarters of the total assets of the banking system. In keeping with sustained economic growth, financial intermediation expanded vigorously but, as a legacy of the monetary instabilities from the 1990s, the bulk of deposits and loans continued to be in, or indexed to, foreign currency. A high degree of 'euroisation', within the framework of a flexible exchange rate regime, makes Serbia's economy vulnerable to exchange rate volatility. Nevertheless, the banking system has emerged largely unscathed thanks to a conservative lending policy and adequate supervision and prudential regulations put in place by the central bank.

Given its limited domestic financial resources, Serbia has had to rely heavily on foreign capital. The liberalisation of long-term capital movements and privatisation opportunities attracted significant foreign direct investment (FDI) in the period to 2006. After 2008, FDI inflows dried up, partly as a result of the crisis.

Road and, in particular, rail transport infrastructure remain insufficiently developed. Following the rehabilitation of the power production and transmission systems, the present electricity demand has been met. However, the existing capacities are far from sufficient in the light of future needs. Investment in new infrastructure and production facilities is part of Serbia's new development strategy, which is looking towards a shift to more export-driven growth, based on higher-tech industries and domestic resources. To that end Serbia needs also to enhance its human capital.

8.2. Assessment in terms of the Copenhagen Criteria

8.2.1. The existence of a functioning market economy

The existence of a functioning market economy requires that prices, as well as trade, should be liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and a consensus on 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

Since 2000, there has been a broad political consensus on the fundamentals of a market economy and economic policies required by EU membership. Serbia has been included in the EU's economic and fiscal surveillance arrangements applying to potential candidate countries since 2006. An appropriate framework for economic policy co-ordination among national stakeholders is in place. The commitment to reforms has been forged by several technical and financial agreements with the EU,

IMF and the World Bank. Macroeconomic stabilisation and recovery in the aftermath of the 2009 global crisis have been anchored by the programmes agreed with the IMF: notably a Stand-By Arrangement in the period from January 2009 to April 2011 and a new 18-month precautionary programme.

Serbia has implemented important market-oriented reforms over the past ten years. However, structural rigidities persist. The new post-crisis development strategy devised by the authorities for the period up to 2020, which is geared to long-term, sustainable and balanced growth, has stepped up efforts to strengthen the economic fundamentals. In particular, significant strides were made towards improving the framework of public finances. Overall, there is consensus on the economic policies required for establishing a market economy, but the remaining structural adjustments need to be implemented without delay.

Macroeconomic stability

After the political changes in 2000, the economic revival regained momentum, with steady and robust average growth of 4.5% per annum in real GDP. Growth was fuelled by domestic demand, which was to a large extent financed by foreign capital. There was a boom in investment activity, in particular, leading to an increase in the share of gross fixed capital formation in GDP from just above 10% in 2001 to close to 24% in 2008. Services, in particular retail trade, telecommunication, financial intermediation and real estate, were the main drivers of growth. The upward trend was interrupted in 2009 as domestic demand failed to provide the usual stimulus in the face of the global financial turmoil. Serbia's output shrank by 3.5% in real terms. The sectors hardest hit by the crisis were construction and manufacturing. The economy bounced back in 2010, with GDP up by 1%, thanks to vigorous export growth while domestic consumption and investment remained constrained. As economic recovery gradually got underway among Serbia's main trading partners, and the dinar continued to depreciate, exports rallied. In 2011, an export-led economic upturn was continuing, but is poised to be affected by the fragile international environment. Its sustainability will depend on the strengthening and expansion of the tradable sector as household consumption and investment have been picking up only slowly given the constraints on disposable incomes. Overall, the global crisis has revealed the vulnerabilities of a growth pattern based on domestic demand and financed by foreign capital inflows. In order to enhance the economy's resilience through sustainable export-led growth, Serbia needs to step up its structural reforms.

Against the background of the pre-crisis growth pattern, which involved a sustained surge in imports to meet accelerating domestic demand, Serbia's balance of payments position deteriorated sharply. The current account deficit increased to over 20% of GDP by 2008. The trade gap widened to 26% of GDP as import growth continued to outpace export growth, which was constrained by low value-added products and low market diversification. The current account deficit narrowed to about 7% of GDP in 2009, following a sharp contraction in foreign trade in the aftermath of the crisis, and also due to a surge in current transfers, mainly in the form of higher net inflows of remittances. Since imports fell much more sharply than exports, the trade deficit was also significantly lower than previous levels but, at 18% of GDP, it was still considerable. In 2010, contrary to expectations that the gradual pick-up in activity and trade would widen the current account deficit, the gap was contained at the 2009 level by strong export growth. As imports have begun to accelerate steadily in 2011 in step with buoyant industrial activity based on strong foreign demand, it remains to be seen whether the recent rebalancing will last. Overall, substantial external imbalances have been reduced in the wake of the crisis, but dependence on external financing remains high.

Table 8.1:

Serbia - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	3.6	5.4	3.8	-3.5	1.0	3.0
Private consumption	Ann. % ch	4.5	0.3	5.4	-2.3	-3.8	:
Gross fixed capital formation	Ann. % ch	14.5	25.6	1.9	-9.1	2.0	:
Unemployment (>15 years old)	%	21.0	18.3	13.6	16.1	19.2	22.2*
Employment (registered)	Ann. % ch	-3.4	-2.1	-1.7	-4.8	-5.2	-3.4
Wages (average, net real)	Ann. % ch	11.4	19.5	3.9	0.2	0.7	-2.2
Current account balance	% of GDP	-10.2	-15.9	-21.4	-7.1	-7.2	-8.4
Direct investment (FDI, net)	% of GDP	14.3	6.4	5.6	4.8	3.0	3.4
CPI (end of period)	Ann. % ch	N.A.	11.0	8.6	6.6	10.3	6.8
Interest rate (3 months)	% p.a.	13.46	6.48	5.20	13.40	10.85	13.04
Stock markets	Index	2,186	4,096	2,604	1,197	1,283	1,411
Exchange rate RSD/EUR	Value	79.11	78.76	89.48	95.88	105.93	102.04
Nominal eff. exchange rate	Index	110.7	102.1	88.6	92.8	89.5	104.0
General government balance	% of GDP	-1.6	-2.0	-2.6	-4.5	-4.6	-4.2
General government debt	% of GDP	37.7	30.9	29.2	34.8	42.9	40.6

* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Serbia gained access to international capital markets following the agreement on debt restructuring with the Paris Club in 2001, by which two thirds of the debt accumulated during the 1990s were redeemed. Driven largely by privatisation, FDI strengthened steadily until 2006, when net inflows amounted to €3.3 billion or 14% of GDP, but diminished thereafter, dropping to a mere €60 million or 3% of GDP in 2010. This was the consequence of the unfavourable conditions abroad, as well as the weak domestic environment, characterised by impediments to doing business and limited privatisation opportunities. Nevertheless, in 2011 FDI has started to pick up.

Given the underdeveloped domestic capital markets, the Serbian corporate sector had to resort to foreign loans to finance its pre-crisis expansion. In the aftermath of the crisis, firms began to deleverage, while domestic commercial banks continued to borrow mostly long term. Against a background of sizeable inflows of foreign resources, official foreign exchange reserves have been largely stable at around €10 billion, i.e. one third of GDP or sufficient to cover some eight months of merchandise imports. Owing to the increasing private borrowing abroad, Serbia's gross external debt grew rapidly. In 2010, it accounted for more than 80% of GDP, of which around one quarter was public debt. External sustainability is a point to watch, especially in the light of the lately modest financial and capital inflows. Overall, cross-border borrowing has led to a substantial increase in Serbia's external indebtedness that will need to be curtailed by attracting more foreign investment.

Despite high levels of economic growth, the labour market remained weak as a result of the restructuring of the economy and of a limited response of the private sector in job creation. The employment rate stayed below 50% and the activity rate at just under 60%. In the aftermath of the crisis, the number of employed persons dropped to a historic low and the unemployment rate soared from 14% to above 20%. Unemployment is a long-term phenomenon and reflects substantial regional disparities. It is particularly high among people under 35 years of age, who account for half of the unemployed persons. Many of the inactive and unemployed are graduates with secondary education or university degrees, which points to a major mismatch of skills. Structural unemployment, in particular among educated young people, suggests that structural rigidities have been hampering the functioning of the labour market. These include a regressive labour tax system and early retirement rules. The poor performance of the labour market has led to a deterioration in social conditions, which had gradually improved during the boom period as a result inter alia of the rapid rise in wages. Since 2009, wage moderation prevailed, largely due to the nominal freeze in public sector wages between 2009-2011. Overall, labour market weaknesses, such as high structural unemployment, a very low employment rate and widespread informal employment, are exacerbated by persistent structural rigidities.

The authorities used monetary policy as a tool to support macroeconomic and financial stability. In particular, the timely response of the National Bank of Serbia (NBS) after the outbreak of the global financial crisis was instrumental in quickly restoring confidence in Serbia's banking system. The guaranteed savings deposit was increased to €50,000, the reserve requirements were gradually relaxed and the tax on interest income from foreign currency savings was temporarily barred. The NBS has committed itself to price stability and since 2009 it has pursued inflation targeting by setting a broad band around the targeted consumer price index (CPI) inflation instead of core inflation, as previously. Under this framework inflationary expectations became broadly anchored and inflation was gradually brought back down to single digits. However, disinflation was interrupted in the middle of 2010 due to rising agricultural/food prices and the knock-on effects of the depreciation of the dinar. By the end of 2010, inflation soared to 10.3% year-on-year, overshooting the 6%±2% target range. The inflation pattern points to major structural shortcomings due to the fact that prices persistently over-react to common external shocks, and inflation remains much higher than in countries with comparable income levels. Following renewed inflationary tensions, the NBS reversed its course of gradually relaxing monetary conditions to embrace monetary tightening by increasing the key reference interest rate to 12.5% in April 2011. However, from mid-2011 the stance has been somewhat relaxed in view of signs that inflation is slowing and the dinar is strengthening, with the interest rate currently at 11.25%. Overall, achieving the price stability objective is a challenge in the face of volatile global commodity prices and structural shortcomings, in particular the slow process of price liberalisation and the knock-on effect of the exchange rate fluctuations.

In 2010, the NBS was actively engaged in preserving exchange rate stability as the pace of the dinar depreciation was deemed to be jeopardising the process of economic stabilisation. Operations on the foreign exchange market became more frequent, especially from mid-May when the pressure on the exchange rate intensified, following the fall out of the Greek debt crisis. In spite of a number of foreign exchange operations and substantial selling of currency reserves on the foreign exchange market, the dinar was on a depreciating path in both nominal and real terms during 2010. Serbia's export competitiveness therefore improved, which led to vigorous export growth. A period of strengthening at the end of 2010 and early 2011 was triggered by an interest rate rise and an increased demand for treasury bills against a lower risk premium. Overall, monetary policy is pursuing exchange rate stability as an implicit priority.

Public finances have been characterised by pro-cyclical fiscal policies during most of the last decade. The overall fiscal imbalance improved in the times of economic prosperity which generated tax-rich revenues and led to a budget surplus of 1% of GDP in 2005. However, since 2006, Serbia's public finances have been continuously eroded by expansionary policies and weak tax compliance. A relaxation of the tax burden was allowed as from 2007 as a result of a new income tax regime and adjustments of indirect taxes. The structure of general government expenditures remained heavily biased towards mandatory current spending, which accounted for over 90% of total public outlays. With a reduced fiscal space and significant pressures on public finances stemming from the economic crisis, Serbia's fiscal position deteriorated significantly after 2008. The expansionary fiscal policy became constrained by the SBA programme requirements. Expenditure savings came largely from a nominal freeze on public sector wages and pensions and restricted hiring in the public administration. Capital outlays were also reduced in order to buffer the dwindling revenues. In addition, an ad hoc temporary tax on mobile services was introduced and excise duties on cigarettes and on oil products were raised, but key tax rates remained unchanged. However, the corrective measures only partly compensated for the sizeable revenue shortfall in the face of a sharp economic downturn, prompting the adoption of supplementary budgets in both 2009 and 2010. In 2010, the fiscal deficit increased to 4.7% as the automatic stabilisers were allowed to come fully into play: additional social assistance and subsidies were provided in response to the weak labour market performance and poor living conditions. In 2011, the budgetary situation remained tense, as revenues underperformed given the slower-than-expected economic upswing. Overall, pro-cyclical fiscal policy undermined public

finances and prompted the adoption of emergency fiscal adjustments to mitigate the deterioration in the wake of the crisis.

The widening budgetary gaps have prompted government borrowing in particular in dinars, in line with the debt management strategy. Higher borrowing and the depreciation of the dinar led to a surge in public debt to almost 43% of GDP in 2010, up by around 8 percentage points compared to the previous year. However, budgetary financing has been difficult given the lack of investor' interest in treasury bills with long-end maturities, due to the significant exchange rate risk. The first 10-year eurobond was issued in September 2011. Also, the recent attempts to raise privatisation proceeds by selling the remaining state owned enterprises were unsuccessful. The government resorted to borrowing from domestic commercial banks. At the end of 2010, foreign debt accounted for almost 60% of total public debt and was predominantly euro-denominated. The issuance of dinar-denominated treasury bills since 2009 has resulted in a steady increase in the share of dinar-denominated debt, as well as the share of short-term debt in the debt portfolio. Nevertheless, the repayment profile of the total public debt remains largely long-term and evenly distributed over time. Overall, public debt sustainability has become an issue of concern in the light of the recently large fiscal deficit, especially given the uncertainties in the macroeconomic outlook, and the budgetary financing by largely short-term commercial borrowing.

Against the background of a significant fiscal deterioration, the authorities took steps to address some of the structural weaknesses of public finances. A multi-annual budgetary process, which is supposed to underpin a more rigorous and efficient medium-term planning, has been formalised in the revised Law on the budget system. The amendments adopted in 2010 established numerical fiscal rules and procedures, including the setting-up of a fiscal council, which determine the path of expenditure-driven fiscal consolidation. A set of general and specific fiscal rules commits the policy makers to cutting the fiscal deficit to 1% of GDP by capping the outlays for public sector wages and pensions, at 8 and 10% of GDP respectively, by 2015 and keeping public debt (without restitution costs) below 45% of GDP. The revised law also defined a new indexation formula for public sector wages and pensions, with three adjustments in 2011 and bi-annual indexation thereafter. The 2010 pension reform will also help in restraining public spending over the long term. The new law, which will be phased in gradually over the period 2011-2022, extends the working period and age for assuming pension rights, tightens up the rules on early retirement and adjusts the indexation mechanism. Although the recent adjustments are an important step forward, further reforms will be necessary in order to enhance the long-term sustainability of public finances. Serbia will need to make additional adjustments in the pension and healthcare systems, as well as to further improve the cost-effectiveness of the public sector. Overall, the recent efforts to strengthen the legal framework of public finances will need to be pursued by means of a rigorous implementation of the new fiscal responsibility provisions and backed by additional systemic changes over the medium-to-long term.

Pre-crisis growth based primarily on the non-tradable services sector, an expansionary fiscal stance and widening gaps in the current account, largely financed through borrowing abroad, have exacerbated the economy's vulnerability to adverse external shocks. The policy mix in place has shown itself to be limited in responding to the global crisis. Counter-cyclical fiscal policies, which would have been necessary to support a rapid recovery, have been constrained by the reduced room for manoeuvre. The effectiveness of monetary policy has been restricted as a result of the high level of 'euroisation' and the effective pursuit of dual objectives by the NBS, namely smoothing the exchange rate depreciation while being committed to inflation targeting. Yet some of the immediate negative effects have been cushioned by the timely stabilisation measures implemented under the IMF programme. The recent strengthening of the fiscal policy framework is an important step in improving the economic policy mix. Overall, the crisis has exposed the economic policy shortcomings and highlighted the need for fully-fledged structural adjustments to gear the economy towards a more sustainable growth path.

Interplay of market forces

Price liberalisation has been ongoing since 2000. However, the market formation of prices has occasionally been challenged as the government capped prices in the face of shortages of some basic food items (dairy products, cooking oil, some types of bread). The government continues to control prices of public utilities, either through government bodies (electricity and gas transmission, transport and distribution, oil pipeline transport, railway passenger transport, some postal services) or sectoral regulators (fixed telephony). The government also sets the limit on increases in the price of communal and public city transport services, which are under the control of the local authorities. As of 2011, oil derivatives imports have been liberalised. A small number of products remain subject to direct price control (medicines). Administered prices account for more than 20% of the CPI inflation basket, with regulated energy prices accounting for around half of this share. Overall, the state control over prices is substantial, as price liberalisation has been slow and occasionally reversed.

Due to the slow progress of privatisation, the state influence in the economy has remained high, with the private sector currently accounting for around 60% of GDP and total employment. The privatisation process was given a boost in 2002 by allowing socially owned companies to be sold through tenders and auctions. The process led to the privatisation of more than 2,400 firms with over 340,000 employees, but it has not yet been completed. About 600 sale contracts signed between 2002-2009 were later cancelled due to non-compliance with some or all of the five standard contract obligations, which brought the number of annulled privatisations to almost one quarter of the firms initially earmarked for privatisation. Given the unfavourable market conditions in the wake of the crisis, the process has continued to be delayed well beyond the official deadline for finalising privatisation of the socially-owned companies by 31 December 2008. Privatisation of the state owned companies is largely incomplete; apart from Serbian Oil Company (NIS) no major firm has yet been reorganised or privatised. The state retains the majority shareholding in the large network industries, such as the national electric power company, the telecoms incumbent operator, the airports, and the air carrier. Although the government announced privatisation strategies for a number of companies, the planned sales did not materialise, as the tenders did not attract the expected demand. To facilitate the privatisation of those enterprises in which the state retains a stake, the government decided to distribute free shares worth 15% of the company's equity to those citizens who have not benefited from any free share distribution in the past. In 2010, the distribution of the remaining state shares was carried out only in the oil company NIS. Privatisation of about 500 utilities in the local communities has not yet begun, as the strategy for their restructuring and reorganisation has still to be defined. Overall, the unfinished privatisation and/or liquidation of socially and state owned enterprises and local utilities remains a challenge in Serbia's transition to a market economy.

Market entry and exit

Since 2005, new companies have been registered centrally with the Business Registers Agency, in line with the uniform registration procedure. For companies dealing with financial activities, prior approval and consent by the competent authority are required. In 2009, the registration procedure was improved by the introduction of the one-stop shop, which provided for simultaneous registration with the tax authorities, the social and health insurance fund and the employment agency. The new system has stimulated business start-ups by reducing the time necessary to register a new company from 23 to 5 days, on average, and by lowering administrative costs. However, the use of different identification numbers in the different state bodies remains an administrative obstacle. Further removal of barriers to doing business has been initiated by a comprehensive regulatory reform. Since its launch in 2009, around two thirds out of 304 recommendations have been adopted and around 36 recommendations are still the subject of parliamentary procedure. Setting-up a new business is hampered in particular by the delays in obtaining construction permits due to the slow and inconsistent implementation of the 2009 Law on planning and construction. Differences in administrative costs across municipalities create additional distortions. Overall, progress was made in facilitating market entry, but the business

environment continues to be marred by complex legislation and red tape, as the implementation of the regulatory reform has been delayed.

A new bankruptcy law entered into force in 2010. At that time, many bankruptcy cases that were opened under the previous law had not been closed. The new law established automatic bankruptcy in cases where the firm's accounts had been blocked for more than 3 years. This resulted in a significant increase in the number of opened cases, which totalled over 2,400 at end-2010. The authorities have initiated actions to regulate out-of-court settlements in order to lower the cost and speed up the privatisation process. Overall, the new bankruptcy law has improved market exit procedures, but the efficiency of the courts remains an issue of concern in view of the considerable backlog of bankruptcy cases.

Legal system

A number of steps have been taken so far to establish a legal system which underpins the market economy. Nevertheless, the business environment has continued to be constrained by shortcomings in the enforcement of the rule of law and the so far unclear situation in relation to property rights. The reliability of land property ownership is being improved since late 2004 through the gradual introduction of the digital real estate cadastre and registration, which is due to be completed by the end of 2011. Amendments to the Law on planning and construction of March 2011 have to some extent addressed these previous shortcomings, in particular by means of simplification of procedures and easier legislation in the case of buildings constructed without permits. However, construction activities have been hampered by the slow implementation of the law.

Restitution of property has been dealt with in a fragmented manner. Agricultural land was already partially returned in the 1990s and a law on the restitution of church property was adopted in 2006. A general law clarifying restitution issues was adopted in September 2011. The new law is an important step to overcome legal uncertainty investors face when acquiring property under the privatisation process.

The scope of the informal economy in Serbia remains substantial. Despite some measures taken in recent years to strengthen the fight against corruption, informal methods of contract enforcement, which by-pass the legal system, continue to be widespread. This is abetted by the lengthy enforcement procedures for court decisions and the major backlog in this area. Overall, in spite of the effort to establish legal predictability, the so far existing lack of legal clarity in relation to property rights has had a negative impact on business activities. Delays and poor enforcement of court decisions and corruption undermine confidence in the legal system among economic operators and hinder investment.

Financial sector development

Serbia's financial intermediation expanded rapidly until 2008, followed by a marked slowdown in financial activities at the onset of the crisis. In 2010, banking sector assets accounted for around 80% of GDP. At the end of 2008, the banking system was challenged by a mass withdrawal of household deposits. The run on the banks had limited effects thanks to ample liquidity and solvency reserves, which was a result of prudent monetary policy and adequate risk-based supervision by the NBS. After the initial financial stabilisation, the NBS adapted administrative and regulatory measures and eased monetary policy to provide additional liquidity in support of the macroeconomic stability. Credit activity to households and enterprises was also sustained as a result of the European Bank Coordination ('Vienna') Initiative, whereby foreign parent banks undertook to maintain their exposure in the Serbian subsidiaries at end 2008 level until April 2010, and keep it at least at 80% by the expiry in March 2011. Overall, the financial sector expansion has been driven largely by the rapid

development of the banking sector, which remained relatively unscathed by the global crisis, thanks to a prudent monetary policy.

Currently, there are 33 banks in Serbia, of which 3 majority state owned, holding a 2.6% market share, and 21 are foreign owned. Foreign banks account for around 70% of the total assets of the banking sector. Subsidiaries of Austrian, Greek and Italian banks are in the top five banks. Among domestic private banks one is the second largest in the market. Overall, the consolidation and privatisation of the banking sector resulted in foreign-dominated ownership.

The banking sector expansion started from a low base and was driven by both the introduction of new products and the strengthening of the deposit base. Deposits, of which 70% are in foreign currency, account for 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. Given the high level of 'euroisation' of the economy, the NBS has put forward a 'dinarisation' strategy. It has initiated steps, such as tightening of the eligibility criteria for foreign currency loans as of mid-2011, improving protection and diversifying financial instruments, with the aim of encouraging lending in dinars. More than half of the loans are granted to the corporate sector (mainly to trade and industry — around 20% each) and about one third to households. Since 2009, when dinar-denominated government securities were introduced, the banks have been increasing their investment in the treasury bills owing to higher yield. Credit growth for the private sector decelerated substantially, but began to pick up after the government put in place a support scheme to subsidise commercial bank loans to companies and households. Overall, the banks' balance sheets continue to be characterised by high 'euroisation', and the monetary authorities have taken steps to rebalance the loan portfolio.

Capitalisation of the banking sector is high due to intense capital growth prior to the crisis. The capital adequacy ratio stands at 20%, well above the 12% threshold imposed by the NBS. However, the asset quality of the banking sector has deteriorated following the modest and gradual rebound from the recession, high unemployment, accelerating inflation and the depreciation of the dinar. Gross non-performing loans (NPL) as a percentage of total loans rose to almost 17% at end-2010, largely due to an increase in the corporate NPL ratio. In the light of this portfolio deterioration and the substantial exchange rate risk related to the high degree of 'euroisation', the Serbian banks are vulnerable to credit risk. Yet the stress tests of the banking system carried out in 2010 concluded that the banks are still sufficiently resilient, given that they continued to be adequately capitalised and liquid. Liquid assets accounted for some 35% of total assets in 2010. Against the background of high capital and reserve requirements, the profitability of the Serbian banking sector was relatively stable but deteriorated slightly in the wake of the crisis; banks' return on assets (ROA) was around 1% and return on equity (ROE) was just below 6%. Despite the rise in NPL, the profitability of the banks improved in 2010 owing largely to sizeable net interest income. Overall, the banking sector is generally sound, but vigilance is required due to the impaired loan portfolio of the banks and a considerable exposure to exchange rate risk.

Non-banking financial institutions account for only a small share of financial intermediation. The insurance market has expanded gradually, albeit from a low base. The sector is supervised by the NBS. At end-2010, there were 26 active insurance companies, 22 in insurance and 4 in reinsurance. 7 insurance companies rely mainly on domestic capital, while 19 are in majority foreign ownership and hold the bulk of the market (more than 90% in non-life insurance and 60% in life insurance). Following a deterioration in performance due to the crisis, the sector saw a surge in profits in 2010. The market capitalisation of the Belgrade Stock Exchange was below €10 billion, i.e. around one third of GDP at end-2010, and annual turnover was at €220 million, down from a peak of over €2 billion in 2007 (90% in shares). Overall, non-banking financial institutions and capital markets play a limited role in the financing of domestic companies.

8.2.2. 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 which allows 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 they need to innovate in order to adjust to a globalised and highly competitive external environment. The more an economy is integrated with the Union before accession, the better it will be able to assume the obligations of membership.

Existence of a functioning market economy

Serbia is a small economy with a state owned sector that is still significant and which remains to be restructured and privatised. Although foreign exchange and trade regimes are liberalised, price liberalisation has been slow. A comprehensive legal framework is in place, but its implementation is ineffective and inconsistent. Throughout the transition, the policy mix has been geared towards macroeconomic stability, but proved to be rather limited in responding to adverse external shocks, of the kind experienced during the recent global crisis. Serbia's economy gradually regained stability owing to the adoption of timely and adequate short-term corrective measures in agreement with the IMF. However, in the wake of the recession, the persistent structural imbalances and weaknesses, such as high and volatile inflation and a low employment rate, have become more pressing. Market mechanisms remain hampered by legal uncertainty, red tape, heavy state involvement, insufficient competition and sectoral distortions. Structural rigidities in the labour market, reflected in high unemployment and the very low participation rate, further constrain both actual and potential growth of the economy. Overall, Serbia has achieved a degree of macroeconomic stability which broadly allows economic operators to make decisions in a climate of predictability. However, Serbia needs to address the rigidities which are preventing the further development of a viable market economy.

Human and physical capital endowment

Serbia's human capital has been slowly strengthening, with a growing participation in all levels of education over time. In 2010, the number of those with high educational attainment stood at less than 9% of the total population and public spending on education was around 3.5% of GDP. Despite high unemployment, the economy suffers from a shortage of skilled labour. The large share of unfilled job vacancies and the persistent structural unemployment of persons with secondary or higher levels of educational attainment point to a major mismatch of qualifications and skills. The adoption of the Law on Education System Fundamentals in 2009 is poised to narrow the gap between demand for and supply of skilled workforce by embracing the entire education system, including vocational education and training (VET). However, supply has been only gradually adjusting to an increasing demand for highly skilled workers, especially in manufacturing. Although the employment agency has designed various programmes to promote cooperation between the labour market stakeholders, self-employment and vocational training – along with lifelong learning – structural rigidities remain important. Further effort will be needed in order to forge an effective link between the education system and vocational training programmes, on the one hand, and the labour market, on the other. Domestic resources devoted to the development of a knowledge-based economy remain marginal; gross expenditure on science accounted for 0.3% of GDP in 2010. Overall, the ongoing skills mismatch continues to act as a drag on the development of new segments of the economy and requires further reforms of the education and training system that would respond better to labour market demand.

Serbia will need to invest significantly given the inadequate and low-quality physical capital stock that is hampering the productive capacity of the economy. After 2001, gross fixed capital formation accelerated steadily – with the share of GDP more than doubling between 2001-2007 – but it was largely fuelled by a boom in real estate. Green-field investment was modest. Given the large gap

between savings and investment of the private sector, the expansion was mainly financed by foreign capital. By end-2010, the FDI inward stock since 2000 amounted to about €15 billion. After 2007, FDI lost momentum while domestic investment has been also declining as a result of scarce local source. However, since beginning of 2011, FDI has started to pick up. Investment was directed mainly to the non-tradable sectors, which also contributed to the growing external imbalances. In cumulative terms for the period 2001-2009, one third of total capital investment was to banks (€1.8 billion), less than one fifth each in the real estate sector (€6.2 billion) and manufacturing (€5.8 billion) and about one tenth each in trade (€4.5 billion) and transport and telecommunication (€4.1 billion). Overall, the previous orientation of investment to predominantly non-traded sectors increased the export capacity of the economy to only a limited extent.

The government has made the reliability of electricity supply through diversified sources of power one of its key priorities. It aims to mobilise financial resources for investment in the energy sector with the support of International Financial Institutions. However, energy efficiency is low and the electricity capacities are being used at levels close to their maximum potential, which is increasingly pushing Serbia to resort to energy imports. The average price of electricity, which was last adjusted in April 2011, is still below the cost-recovery level and is restraining new investment. Overall, energy infrastructure will need to be modernised and extended in order to strengthen industrial activity.

The telecommunications infrastructure is fairly well developed. Fixed telephony, operated by the telecoms incumbent in majority state ownership, has been partly digitalised. Mobile telephony density has increased, following the market entry of two foreign operators. However, access to broadband network and internet use by business remain low. Overall, telecommunications are not a constraining factor to doing business, but a higher broadband penetration is needed in order to develop higher value-added segments in the industry.

Transport infrastructure needs to be further developed in order to enhance the country's economic potential. The construction of new roads has been making very slow progress. The rail network is obsolete due to the lack of significant investment in past decades. There are plans for an upgrade of 750 kilometres of railroad, including the laying of a second track, along the Pan-European transport Corridor X with the support of International Financial Institutions. Overall, transport infrastructure has suffered from insufficient investment.

Sector and enterprise structure

The structure of Serbia's economy has undergone significant changes during the last two decades. Services currently contribute more than 60% of GDP, agriculture approximately 10% and industry 23%. While the metal, electronic and textile industries previously dominated, production became diversified during the last decade, especially into the food and beverages sector. The global crisis had an adverse impact on manufacturing and construction.

Public companies still generate around 40% of Serbia's output. However, their performance has been undermined by the crisis, with the erosion of capital and accumulated losses rising to over €3 billion, i.e. more than a quarter of their total capital at end-2010. Private companies account for the bulk of foreign trade. Around 75% of Serbia's exports are undertaken by companies that are predominantly under foreign ownership. The informal sector, taking advantage of weaknesses in tax and expenditure policies, and also in law enforcement, including the fight against corruption, remained significant. Overall, the structural adjustment of the economy has been lagging behind due to the very slow pace of the reform process, and performance has been marred by the economic crisis. The informal sector poses a major challenge.

Serbia's restructuring process has translated into a steady rise in the share of small and medium-sized enterprises (SMEs) in the economy. Currently, the majority of private enterprises are micro

companies. SMEs contributed around 57% to the gross value added of the non-financial sector and accounted for about two thirds of overall employment. The sector has been facing diminishing demand, stricter financing conditions and increasing payment arrears since the crisis broke. This resulted in illiquidity and indebtedness which led the government to adopt measures aimed at facilitating access to financing, although so far this has had little effect. Overall, although SMEs have increased their share of the economy, they face constraints in both their current activities and in obtaining finance for investment.

State influence on competitiveness

State subsidies were cut from 3.3% of GDP in 2005 to 2.3% of GDP by 2009, but they surged to 2.6% of GDP in 2010 as a result of sizeable stimulus packages designed to support the economic recovery. The programmes, inter alia, included direct subsidies to companies for job-creating investment projects as well as financial assistance for concessional borrowing in dinars by business and citizens alike. The legislation regulating State aid control was adopted in 2009 and needs to be consistently enforced, in particular as regards effective monitoring by the State aid authority. The state-controlled monopolistic structures remain in place in a number of sectors, particularly in energy, telecommunication and postal services, but also in agriculture and tourism. Overall, state influence on competitiveness through legal and financial mechanisms is substantial.

Economic integration with the EU

Since 2000, Serbia has been continuously strengthening trade links with the EU, which accounts for almost 56% of Serbia's total merchandise trade; in 2010 the share of exports stood at 60% and that of imports at 55% of the respective totals. During the period 2005-2010, two thirds of total inward investment to Serbia originated from the EU and EFTA countries, with the largest FDI inflows coming from Austria, Greece and Norway. The pace of integration with the EU advanced in step with Serbia's international competitiveness. In the period 2001-2007, real wage growth was broadly in line with labour productivity growth, but the appreciation of the dinar against the euro led to rising real unit labour costs. During 2009-2010, export price competitiveness improved thanks to a rapid depreciation in the real effective exchange rate. Overall, improved export competitiveness since 2009 helped to further Serbia's economic integration with the EU.

8.3. Conclusions

As regards the economic criteria, Serbia has taken important steps towards establishing a functioning market economy and achieved a certain degree of macroeconomic stability in spite of the global economic and financial crisis. However, further efforts will be necessary for restructuring the economy and improving the business environment, in particular by strengthening the rule of law and removing red tape, enhancing competition and the role of the private sector as well as tackling rigidities on the labour market. In order to enable it to cope in the medium term with competitive pressure and market forces within the Union, Serbia needs to pursue structural reforms to upgrade the productive capacity of the economy and create a climate conducive to increased foreign investment.

There is a broad political consensus in Serbia on the fundamentals of a market economy as well as a track record in the implementation of economic reforms. Serbia achieved a degree of macroeconomic stability that allows economic operators to make decisions in a climate of predictability. The economic policies of the past decade supported steady growth of close to 5% on average, gradually declining inflation and a general improvement of living standards. However, the global financial and economic crisis exposed the vulnerabilities of a growth paradigm, which was based on domestic demand financed largely by borrowing abroad, as well as the ensuing limitations of the policy mix to respond effectively to adverse external shocks. Recently, substantial progress has been made towards strengthening the financial framework and the quality of public finances, which would underpin a

shift to more sustainable and balanced growth, driven by exports and investment. The free interplay of market forces has developed, albeit at a slow and uneven pace, through privatisation and liberalisation of trade and prices. Progress has been achieved in facilitating market entry and exit. Economic integration with the EU is high.

A number of structural weaknesses persist and hamper the economic performance. The state influence in the economy has remained high due to the slow progress of privatisation and price liberalisation. In spite of the steps towards establishing legal predictability and removing red tape, the business environment continues to be constrained by legal uncertainty. Lengthy enforcement procedures for court decisions undermine trust in the legal system. Lack of competition in certain sectors and significant infrastructure bottlenecks are a further drag on the economic potential. Foreign direct investment was relatively strong prior to 2008 and, following a substantial drop during the economic crisis, has started to slowly recover, but Serbia needs to further improve the investment climate. Against a modest economic recovery, unemployment remains high and the social situation strife. Serbia needs to urgently address structural rigidities on the labour market, including the mismatch between demand for and supply of skilled workforce. The informal economy remains an important challenge.

9. KOSOVO (Under UNSCR 1244/1999)

In examining 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

As a consequence of the political instability and early elections, the 2011 budget was not passed by the Assembly until the end of March. In April the government adopted its medium-term expenditure framework (MTEF), covering the years 2012-2014. The SDR 92.7 million (€109 million) Stand-By Arrangement (SBA), negotiated with the IMF in mid-2010, went off track, notably due to a significant wage increase in the government sector. A non-disbursing IMF Staff Monitored Programme (SMP), running until the end of 2011, was agreed upon in June. The SMP, which entails conditionality, is an important test and attempt to regain credibility in economic and fiscal policy. Overall, the determination to pursue market-oriented economic policies has been maintained, but measures were adopted that introduced severe distortions in the economy. Designing and implementing a coherent and credible economic strategy, linking policy priorities, structural reforms and public expenditure, remain a major challenge.

Macroeconomic stability

The economic situation is challenging. The large increases in the budget deficit over the last two years have not managed to spur economic growth significantly. The 2010 national accounts data are still not available, but external and fiscal imbalances increased, driven by another year of public-sector expansion. Private consumption growth is likely to have remained subdued due to the almost unchanged remittances, low job creation and accelerating inflation. The contribution of government's final consumption to real GDP growth, although supported by nominally increasing public expenditure, has been constrained by a continuous winding-down of the donors consumption. Government investment remained buoyant, but there are uncertainties surrounding private investment developments, as bank lending and foreign capital inflows have been channelled mainly into non-investment activities in the services sector. Exports of goods and services performed impressively, increasing by 36%. Starting from a very low base, they increased their share in GDP to about a fifth. Imports of goods and services also increased in double-digits, although at a lower rate, widening the negative contribution of net exports to growth by about 1 percentage point. Economic statistics remained weak, hampering a comprehensive assessment of the economic situation. GDP per capita is estimated to have risen at €2,385 in 2010, equal to 9.7% of the EU-27 average (9.6% in 2009). Overall, Kosovo's economic growth remained weak and fragile.

In 2010, led by a doubling of base metals exports, total exports of goods increased nominally by more than 70%. In 2011 they continued performing strongly, although their growth went down significantly to 19% by the end of July. Exports' share of GDP rose to 7.4%, up from the very low 4.5% in 2009, driven by strong foreign demand and high commodity prices. This positive trend masks an underlying weakness, as base metals increased their share in total exports to almost two-thirds, revealing a lack of diversification and the predominance of low value added goods in the exports' structure. Imports of goods rose by 11% in 2010 and accelerated their growth to 14% by the end of July 2011. Their share in GDP climbed to 49%, up from 47.3% in 2009. The imports structure shifted towards intermediate and consumption goods at the expense of capital goods.

The coverage ratio, i.e. exports of goods as a percentage of imports (12-month moving average), has increased and stood at 14.1% in July 2011. The net exports of goods displayed a better performance

than in 2009, but the deficit in goods and services worsened from 39.2% of GDP in 2009 to 40.5% in 2010. The surplus in services dropped substantially due to a significant increase in imports of construction services starting in the second quarter of 2010. In the first seven months of 2011, the trade deficit widened to €1,122 million compared with €992 million in the corresponding period of the previous year, as gains on the exports side were more than offset by increased imports of goods.

Table 9.1:

Kosovo - Main economic trends

		2006	2007	2008	2009	2010	2011 H1
Gross domestic product	Ann. % ch	3.4	6.3	6.9	2.9	N.A.	N.A.
Private consumption	Ann. % ch	4.3	10.0	8.6	1.5	N.A.	N.A.
Investment	Ann. % ch	1.3	4.1	15.3	10.7	N.A.	N.A.
Unemployment	%	44.9	43.6	47.5	45.4	N.A.	N.A.
Employment	Ann. % ch	-10.1	8.1	-12.9	8.7	N.A.	N.A.
Wages	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Current account balance	% of GDP	-7.2	-10.4	-16.3	-15.4	-16.0	N.A.
Direct investment (FDI, net)	% of GDP	9.3	12.7	8.9	7.2	7.5	N.A.
CPI	Ann. % ch	0.6	4.4	9.4	-2.4	3.5	9.6
Interest rate (3 months)	% p.a.	15.38	15.25	16.61	14.11	18.24	18.69
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	-2.8	-0.1	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	2.5	7.1	-0.1	-0.7	-2.7	N.A.
General government debt	% of GDP	N.A.	N.A.	N.A.	6.5	N.A.	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

In 2010, the current account deficit (including official transfers) widened to 16.0% of GDP, up from 15.4% in 2009. This increase was driven mainly by the deteriorating services account. At the same time, the surplus on the income account improved to 3.1% of GDP as investment income outflows declined by about 40% over the previous year. Current transfers remained significant at 21.6% of GDP. Net workers' remittances, a major source of financing domestic demand, increased by about 6% but their share of GDP remained almost unchanged at 10.2%. The surplus on the capital and financial account (12.3% of GDP) fell short of the size of the current account deficit. Net foreign direct investments increased to 7.5% of GDP, about a third of which went into real estate and construction and another 22% into financial services. There was a spike of about 50% in FDI inflows in manufacturing, associated with the completion of privatisation deals rather than new green-field investments. Over 2010, currency and deposits held abroad were converted into portfolio investments abroad (equity and debt securities). This was accompanied by an increase in the central bank reserve assets. Net errors and omissions of 3.7% of GDP are high in comparison with the 1.5% in 2009 and pose a problem when it comes to proper analysis of economic developments. Overall, external imbalances are high, especially in trade in goods, and production-enhancing foreign investment inflows have remained limited.

Unemployment was very high at 45.4%, according to the latest official data from the Labour Force Survey 2009. No data are available on the unemployment rate in 2010 because the Labour Force Survey was cancelled due to financial constraints. In 2010, the number of registered unemployed went down by about 1%, mostly in the unskilled segment. Nevertheless, by the end of June 2011 unskilled unemployed still accounted for 60% of total registered job-seekers. Unemployed with university education, although a relatively small number, have steadily increased and approached 4,000, signalling problems in the functioning of and the links between the labour market and the education system. Data from the Kosovo Pension and Savings Trust Fund indicate that in 2010 the number of contributors increased by 2.3% or 5,213 people, almost equally divided between the government and non-government sectors. The statistics available do not provide a true picture of the labour market, particularly given the significant informal employment. Overall, information about the labour market is scarce and doubts about its accuracy persist. Unemployment remained very high and the economy

did not create enough jobs to reduce pressures on the labour market and offer job opportunities, especially to young new entrants.

The annual average inflation was 3.5% in 2010. Monthly inflation rates accelerated sharply from mid-2010 on and in the first quarter of 2011. By March 2011 inflation peaked at double-digit levels of 10.8% (year-on-year), before it slowly decelerated to the still high 5.3% by the end of August. Food prices were the main contributor to inflation with 3.5 percentage points, followed by energy-related items with 0.9. Core inflation (non-food and non-energy) reached a high of 1.6% in May, after it had usually remained below 1%, spurred, inter alia, by the government promise to increase government-sector wages substantially. About 90% of all goods in the consumer basket exhibited increasing prices, indicating broad-based inflationary pressures. The inflation level and structure have hit the poor disproportionately and put under strain consumption patterns dependent on remittances. Overall, inflation has been volatile and risen to high levels.

Kosovo is using the euro as legal tender. Consequently, the Central Bank of Kosovo (CBK) has only limited policy instruments. The growth in broad money (IMF definition) stood at 18.7% by the end of July 2011. Its dynamics throughout the period was influenced by the reduction in public non-financial corporations' deposits due to the withdrawal by the government of dividends from the publicly-owned telecommunications company. The monetisation of the economy, measured by the ratio of average broad money to GDP, increased slightly, from 39.8% in 2009 to 40.4% in 2010. Stricter bank supervision led to reclassification of some loans and an increase in non-performing loans, which reached 5.9% of total loans by mid-2011. The central bank has put the biggest micro-finance institution under direct administration. This case has highlighted weaknesses in the legislation, in particular on the licensing of micro-finance institutions. Overall, the monetary framework continued to function relatively well, although there is room for improvement, in particular in regulation and supervision of the financial sector.

The budget deficit increased from 0.7% of GDP in 2009 to 2.7% in 2010, driven by surging expenditures and lower dividend receipts. The underlying deficit was much higher – 5.5% of GDP – if one-off receipts, particularly a €85 million dividend and a €30 million budget grant, are taken into account. In addition, there has been a significant increase in unpaid invoices, which stood at 0.7% of GDP at the end of 2010. Total revenue (excluding dividends and grants) increased by about 1 percentage point to 25.3% of GDP. Total primary expenditure increased by about 0.7 percentage points to 30.7% of GDP. Two thirds of the underlying revenue continued to be collected as border taxes on consumption, while direct tax revenue decreased in not only relative but also absolute terms. Current expenditure reached 18.1% of GDP, up from 17.7% in 2009, underpinned by a strong increase in spending on wages and salaries. Social transfers went up by 0.3 percentage points to 4.8% of GDP. Total subsidies, capital transfers and net lending to publicly owned enterprises went down by 1.3 percentage points to 3.2% of GDP, due to a reduction in spending on the Kosovo Energy Corporation. Capital expenditure increased from 9.9% to 10.7% of GDP, although all categories of capital expenditure, other than those related to construction of the highway linking Pristina and Tirana, had been cut significantly by 2.2% of GDP. The government deposits available at the central bank dropped from €342 million (8.7% of GDP) in 2009 to €244 million (5.9%) at the end of 2010. Government debt to the World Bank and the IMF stood at 6.2% of GDP.

Due to the early dissolution of parliament, the 2011 budget was delayed and was not adopted by the new Assembly until March. It envisages a 17% increase in revenue (excluding dividends and grants) over 2010, 17.2% higher total primary expenditure, and a budget deficit of €227 million (4.7% of GDP). The budget foresees that the deficit would be financed by direct grants, privatisation receipts from the sale of Post and Telecommunications of Kosovo (PTK) and borrowing from international financial institutions, most of which are unlikely to materialise in 2011. In the first eight months of 2011, budgetary execution has been marked by strong tax revenue performance (17% annual growth) driven mostly by equally strong imports of goods. In the first quarter, expenditure lagged behind,

especially at municipal level, but by end of August total expenditure accelerated and increased by more than 24%. The budget turned into a deficit of € 16.6 million mainly because of particularly strong increases in spending on wages and salaries (25%) and capital outlays (61%). The Ministry of Finance took steps to improve the transparency of budget execution and started uploading preliminary monthly information about budget revenue and expenditure onto its website. However, budgetary transparency could be further improved. Overall, the financing of the 2011 budget is facing significant risks.

In 2010, in an attempt to rationalise and bring predictability to economic policy, Kosovo entered a Stand-By Arrangement with the IMF. The agreement allowed sufficient room and time for adjustment of the significant fiscal imbalances. Nevertheless, after a series of ad hoc measures, the programme derailed. In addition to the Labour Law adopted in the last session of the previous Assembly, a number of initiatives with a potentially significant negative impact on the level and quality of government expenditure were taken without prior analysis of their economic and budgetary impact.

The government decision to increase government employees' wages substantially (by 30 to 50%), later incorporated in the 2011 budget despite the objections raised by the European Commission and the IMF, was highly detrimental to fiscal sustainability and the quality of spending. In mid-July 2011, the government entered into a new agreement with the IMF – a non disbursing Staff Monitored Programme (SMP) due to run until the end of 2011. Under the programme, the government committed to consolidation measures totalling € 35 million and to set aside a reserve of € 60 million as unallocated expenditure for 2011, the release of which is linked to announcement of the winner of the PTK privatisation bid. This reserve is crucial for preserving a minimum level of government bank balances by the end of 2011. However, keeping it is likely to imply cuts in non-highway capital spending, which is one of the most growth-enhancing categories of expenditure. The implementation of the SMP is an important test and an attempt to restore credibility to economic and fiscal policy. Overall, fiscal planning and the quality of public finances deteriorated further and policy predictability, consistency and transparency remain serious challenges.

Economic development continued to be marked by fragile growth and significant domestic and external imbalances, aggravated by poor fiscal policy. In particular, the high inflation and dysfunctional labour market pose major challenges for economic and social cohesion and the significant economic uncertainty remained an obstacle to job creation and private-sector development. In 2011, in an attempt to remedy some of the major policy weaknesses, the government presented an economic vision and action plan for economic reform. This is commendable for the leading role given to the private sector in sustainable economic development. However, the plan lacks prioritisation and sequencing of proposed measures. It relies on an optimistic macroeconomic scenario. Careful assessments and proper fiscal impact analyses of most of its measures are still due. In addition, the plan's medium-term budget deficit target of 2% of GDP is inconsistent with the 0.5% deficit envisaged in the MTEF. Overall, the proper functioning of the macroeconomic policy mix is increasingly threatened by the unpredictable fiscal policy and unsustainable growth in government expenditure.

Interplay of market forces

About 90% of the publicly-owned enterprises (POEs) had operating profits in 2010, but a few big energy and mining companies continued to suffer large losses and have been a significant drain on the budget. The Privatisation Agency of Kosovo continued the privatisation of socially owned enterprises (SOEs). Mainly small businesses were privatised, with the exception of a big cement factory (which will secure employment for the 500 workers for three years). Limited progress was made with liquidating SOEs: only one in 2010. The privatisation of publicly owned enterprises had temporarily stalled because of the early dissolution of parliament. The process of privatising PTK resumed in the spring. In June 2011 two companies, out of the five which had declared interest, qualified for the next

stage. In September, the government gave two additional weeks for expression of interest to the companies which had not qualified in June. This extension potentially undermines the credibility of the privatisation process. The privatisation of KEK Distribution and Supply (KEDS) also proceeded, with four companies pre-qualifying to participate in it. The transaction for development of the New Kosovo Power Plant (NKPP) continued to suffer delays, partly related to the future energy market model and the long-term power purchase agreement between the NKPP and KEDS, which still needs to be finalised in detail. Overall, there has been some progress with the privatisation process, especially concerning publicly owned enterprises.

Market entry and exit

The business register now includes 105,000 companies. Data from the Tax Administration of Kosovo (TAK) show that around half of them are actually inactive. In order to be deregistered after becoming inactive, companies have to present the business register with a statement from TAK that all outstanding tax obligations have been fulfilled. So far, online registration of companies is possible only at the 'one stop shops' or municipal business centres that have been established in 22 municipalities. Businesses continued to suffer from power cuts and most firms identified corruption and red tape as major impediments to doing business. As part of its economic development action plan, the government announced its goal of improving the business environment substantially. To this end, it plans a number of measures, including a comprehensive reform to remove 50% of licence and permit requirements in the medium term. Overall, weak administration, unreliable electricity supply and deficient rule of law continued to hinder market entry and exit.

Legal system

The legal system continued to suffer from poor accessibility and efficiency. Weak enforceability of contracts remained one of the main concerns of companies and investors in Kosovo. It is also one of the factors explaining the relatively high interest rates charged by commercial banks to the private sector. The Kosovo court system, in cooperation with EULEX, is investigating several high-profile corruption cases. Senior officials and politicians have been convicted.

There has been some progress regarding property rights infrastructure. All Municipal Cadastre Offices are now connected to the central Kosovo Cadastral Agency and records are available in both places. Over the last few years, both registered transactions and mortgages have increased, indicating use of property as collateral. A total of 5,364 mortgages were registered in 2010 and 2,712 in the first eight months of 2011. It takes about 15 days for the Municipal Cadastre Offices to register a transaction. Some land registry books remain in Serbia. An agreement on cadastre was reached within the framework of Belgrade/Pristina dialogue. The agreement needs to be implemented. Expropriation procedures are not always applied and property owners are not always consulted or adequately compensated. Overall, the existing legal framework is underdeveloped and its implementation remained poor. The difficult, lengthy and costly legal enforcement of contracts and prevalent corruption continued to hamper the business environment.

Financial sector development

The financial sector expanded by 13.7% in 2010, taking the total value of assets to €3.2 billion or about 78% of GDP. The banking sector is predominant and accounted for 77% of all assets, followed by pension funds (15.4%), microfinance institutions (4.3%), insurance companies (3.1%) and financial intermediaries (0.2%). The number of commercial banks (eight), pension funds (two) and insurance companies (eleven) remained the same, whereas two microfinance institutions had their licences revoked in 2010 (reducing their number to 17). The degree of concentration of the banking system remains high, with 77.4% of the assets managed by three banks. About 90% of the assets in the sector are held by banks under foreign ownership. In 2010, boosted by growing interest income,

the retained profit of the banking sector increased by 30%. The return on average assets remained unchanged at 1.4%, whereas the return average equity increased to 14.9% compared with 13.9% in 2009. Non-performing loans increased from 4.3% of total loans in 2009 to 5.9% in mid-2011 but the banking system's capital adequacy ratio remained solid above 17%. While interest income continued to rise moderately in the first half of 2011, provisions for loans and other assets losses have doubled in comparison to the same period in 2010 and suppressed profitability. Overall, financial intermediation continued to deepen and, despite increasing non-performing loans, the banking sector remained stable and profitable.

Credit gained some speed, increasing by 13.2% (year-on-year) in 2010 to 35% of GDP. Its growth accelerated to 15.3% by the end of July 2011, with both households and non-financial corporations rates of annual credit growth in the double-digits – 17.2% and 13.2%. Almost all of the increased corporate lending went to the services sector, in particular to wholesale and retail trade, and, partly, to the construction sector. The share of lending exposure to manufacturing and agriculture decreased over the period, reflecting the low level of domestic production and the high dependence of the economy on imports. The maturity of loans was extended slightly and loans with a maturity longer than two years increased to 73% of the total loan portfolio in 2010, up from 70% in 2009. This trend was reversed sharply in May, following a spike in borrowing of up to two years, whereas the long-term loan segments stagnated.

In 2010, total deposits increased to 47.1% of GDP, up from 44.6% in 2009. Deposits structure and growth rates have been skewed because of significant withdrawals of deposits of public non financial corporations related to payments of PTK dividends. Total deposits grew by 15.7% by the end of July. Household deposits, which made up about 70% of the total, have had a remarkably robust growth, increasing by about 18%. The loans-to-deposits ratio increased over 2010 to 75.3%, and then further to 81.2% in July 2011, close to the informal benchmark of 80% loans-to-deposits ratio. The 12-month moving average effective interest rate on deposits was on a clear downward path over the period and stood at 3.5% in July. The average effective interest rate on loans has also gone down a bit to 14.5%, but the average spread remained above 11 percentage points. Overall, the deposit base and credit activity continued to increase but 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 is increasingly threatened by unpredictable fiscal policy in an environment of persistent and increasing domestic and external imbalances. The vulnerabilities of the policy mix increased due to the significant budgetary deficit and limited financing options. Unemployment is very high, revealing deep structural problems in the economy. Overall, the weak rule of law, corruption, high level of informal activities, and ad hoc policies have increased economic uncertainty and deep structural problems continued to hamper the economy.

Human and physical capital

Some progress was made with access to education, given the considerable investment in school infrastructure, specifically for basic education (grades 1-9). Education is one of the largest government programmes, accounting for about 13% of total spending (3.9% of GDP), although resources allocated to it still remain relatively low. Due to the high proportion of school-age children in Kosovo's population, spending per pupil is lagging even further behind. More than half of all the teachers in elementary and secondary schools are only with secondary or higher education. Educational results are generally poor. About 42% of all secondary school students managed to pass the 2011 final exam ('Matura') at the first trial in June and the pass rate of vocational school pupils was only 25%. In 2010, the Ministry of Education, Science and Technology (MEST) produced a

comprehensive sector strategy (2011-2016) which recognises the importance of an inclusive system of education by expanding access to basic and upper secondary education and renewing plans for expanding pre-school education. In August 2011 the government has officially adopted the strategy. Kosovo still lacks accurate data on the number of students and the employment rate of graduates. Schools continue to operate on multiple shifts. The research capacity of universities and research institutes in Kosovo remains very weak. The Investment Promotion and the Small and Medium-sized Enterprise (SME) Agencies have set up an online catalogue of education institutions in Kosovo in order to enhance cooperation and transfers of expertise and technology to SMEs. Overall, the education sector is still affected by the lack of adequate facilities and characterised by poor outcomes.

Total investment stood at around 30% of GDP in 2010, almost unchanged over the previous year. Public investments (predominantly in road infrastructure) expanded but the growth in private investments appears to have been curtailed, judging from the 13% annual reduction in imports of capital goods. Construction of a highway towards Tirana continued and the first 34 km are scheduled to be opened to traffic by the end of October 2011. However, the scale of the project is not proportionate either to the forecast traffic or to the available resources and is crowding out other expenditure. Not much has been done to improve energy infrastructure and efficiency. Overall, there were marginal improvements in physical capital. The efficiency of government capital spending is questionable and information about the level and structure of private investments remained scarce.

Sectoral and enterprise structure

Kosovo's enterprise sector remains dominated by small and micro-enterprises. About 99.7% of the enterprises employ less than 50 people, contributing about 60% of the overall turnover in the economy. Access to and the cost of finance remained problematic, mainly due to the high risks in the economy. Measures to improve access to finance for SMEs are envisaged in the SME strategy adopted in July 2011.

In order to attract investors, the government is considering long-term power purchase agreements of up to 20 years between the new generation company and the distribution and supply company. In a similar vein, it is contemplating recommending a possible multi annual ban on new entrants to the market for mobile telephone service-providers. Measures such as these would hinder competition. In 2010, KEDS's billing and collection rates improved slightly, supported by the lack of electricity price increases, but they still remain low.

The informal sector is fuelled by weaknesses in tax and expenditure policies and, in law enforcement, including the fight against corruption and organised crime. It reduces the tax base and the efficiency of economic policies. As a measure to combat the informal economy, the Kosovo tax administration continued to issue fiscal numbers and to install fiscal cash registers. However, these registers are still not systematically used. Overall, the enterprise structure remained unchanged. The large informal sector poses a big challenge.

State influence on competitiveness

A Law on State aid was adopted in July 2011. Under this law, State aid will be granted mainly for social purposes. The Law provides for the State Aid Commission to approve State aid, which will be monitored by the Competition Commission. Budget subsidies and capital transfers to publicly owned enterprises totalled 1.7% of GDP in 2010, down from a high of 2.4% in 2009. Another 1.5% of GDP were channelled to support the investment programme of the Kosovo Electricity Company. Electricity prices remained unchanged, below cost-recovery levels. The government has set up a limited grant scheme consisting of coupled payments to cereal and livestock farmers and matching grants for the dairy, fruit and vegetables sectors at farm level. It has also announced plans to substantially increase direct agricultural subsidies which, in view of the level of development of the sector, may be

inefficient in comparison with other more structural support measures. Overall, state interference in the economy remained high but broadly unchanged.

Economic integration with the EU

The openness of the economy, measured by the value of imports and exports of goods and services in relation to GDP, increased to 81.2% from 70.5% in 2009. Exports to the EU Member States recovered from a slump in 2009 and grew by 84%, accounting for 45% of total exports of goods. Exports to CEFTA countries increased by 33%, although their share declined from 32% to 24%. Since the beginning of 2011, after the expiration of the autonomous trade measures and due to a delay in their renewal, Kosovo no longer benefits from preferential access to the EU market. The EU and CEFTA countries remained the main origin for Kosovo's imports, with shares of 38.3% (39% in 2009) and 37.2% (35.8% in 2009) respectively. With about two thirds of the new foreign investment inflows in 2010, the EU countries were the biggest investors in Kosovo. Overall, economic integration with the EU remains significant.

9.3. Conclusions

The economy of Kosovo has continued to be characterised by fragile growth and significant domestic and external imbalances, aggravated by an unpredictable fiscal policy stance. The high inflation and dysfunctional labour market represent major challenges for economic and social cohesion. A series of ad hoc measures and lack of commitment by the authorities derailed the Stand-By Arrangement with the International Monetary Fund (IMF). The new non disbursing agreement with the IMF, to run until the end of 2011, is an important test for Kosovo to regain credibility in economic and fiscal policy. High uncertainty remained an obstacle to private sector development. Firms are confronted with weak administration, lack of reliable electricity supply, deficient skills of workers, poor infrastructure and deficient rule of law.

As regards the economic criteria, Kosovo has made no 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.

The monetary framework has continued to function relatively well, although there is scope for improvements, in particular in financial sector regulation and supervision. Financial intermediation has continued to deepen and the banking sector has remained stable and profitable, despite increasing non-performing loans. There has been some progress with the privatisation process.

The proper functioning of the macroeconomic policy mix has been increasingly threatened by an unpredictable fiscal policy, unsustainable government expenditure growth and limited financing options. Poor governance and ad hoc measures have negative impact on the private sector and deep structural problems continue to hamper the economy. Inflation has been high and volatile. Unemployment has remained very high and not enough jobs have been created to reduce pressures on the labour market and offer employment opportunities, especially to the young new entrants. The external imbalances have also remained high, especially in the trade in goods, and production-enhancing foreign investment inflows have remained limited. The public electricity company have continued to receive substantial subsidies from the state budget and loans for financing of its investment programme. The weak rule of law and challenges related to property rights have continued to impact negatively on the business environment. 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
MTEF	Medium-Term Expenditure Framework
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
UNSCR 1244	United Nations Security Council Resolution 1244