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Progress towards meeting the economic criteria for EU accession: the EU Commission's 2013 assessments

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European Commission
Directorate-General for Economic and Financial Affairs

Progress towards meeting the economic criteria for EU accession:

the EU Commission's 2013 assessments

EUROPEAN ECONOMY Occasional Papers 166

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* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

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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 2013 European Commission's Progress Reports, i.e. the Staff Working Documents for each candidate country and potential candidate for EU accession.([1]) The Commission prepared reports for the five candidate countries the former Yugoslav Republic of Macedonia, Iceland, Montenegro, Serbia and Turkey as well as for the three potential candidates Albania, Bosnia and Herzegovina, and Kosovo. The European Commission adopted the Progress Reports on 16 October 2013.

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 countries and the potential candidates towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2013 Progress Reports.

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.

([1]) In the case of Iceland, the Commission's staff working document (SWD) contains a brief assessment of compliance with the accession criteria, covering progress made by Iceland in the period September 2012 to May 2013, when the new Icelandic government decided to cease contributing to the SWD. This Occasional Paper however contains the full-fledged economic assessment as prepared by ECFIN staff.

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 candidates 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 candidates 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. This exercise has not yet been undertaken for the potential candidates, and therefore the assessment and the conclusions can naturally only refer to further progress achieved rather than to level of compliance.

Progress towards meeting the economic criteria for EU accession: the EU Commission's 2013 assessments

1. 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.

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

There is a broad political consensus among political parties on maintaining the key essentials of a market economy and the preservation of a welfare state. The authorities continued to proceed with domestic debt restructuring, financial sector stabilisation and fiscal consolidation. Despite some fiscal slippage, the authorities maintained a reasonable track record of keeping previously announced policies and other commitments. The country submitted its third Pre-Accession Economic Programme (PEP) in January; its fiscal strategy targets a marked reduction of the public debt ratio to around 80 % of GDP by 2015. Overall, a broad consensus on economic policy essentials has been maintained.

Macroeconomic stability

In 2012, the Icelandic economy recovered for the second consecutive year from a sharp recession, albeit with decelerating dynamics. Average GDP growth fell to 1.4 %, down from 2.7 % the year before. In particular, investment growth slowed markedly. Private consumption remained rather strong, increasing by 2.4 % year-on-year, slightly weaker than the year before. Public consumption remained constrained. Annual export growth lost some momentum during the year. Import growth slowed, from 6.7 % in 2011 to 4.7 % in 2012, probably reflecting weaker investment. Data on the first half of 2013 point to GDP growth of 2.2%, mainly driven by private consumption, while investment remained weak. Tourism was an important source of growth. Average per capita income (in Purchasing Power Standards) remained at 112 % of the EU average in 2012. Overall, the economy continued to recover, but uncertainties regarding the growth dynamics have persisted.

Iceland's external imbalances were lower than a year before. However, in the second quarter of 2013 most components of the balance-of-payments deteriorated again. The trade balance deteriorated from a surplus in the first quarter of some 6% of the quarter's GDP to a slight deficit of 0.5% in the second quarter, mainly due to a drop in export earnings. Commodity imports declined too, but to a lesser extent, probably reflecting continuously weak domestic investment. The service balance benefitted from solid tourism revenues. When external accounts are corrected for hypothetical interest payments (on loans that will probably be written off), the 'underlying' current account is largely balanced.

The stock of external debt declined but still remains high. When correcting for foreign debt of banks and holding companies in winding-up proceedings, the external debt stock increased from 156 % of GDP in mid-2012 to some 160 % in the second quarter of 2013. Iceland's net international investment position stood at minus 60 % of GDP at end-2012, which is still rather high. Iceland's balance of payments situation remained sheltered by capital controls. Foreign exchange reserves dropped between September 2012 and July2013, from 30 % of GDP to some 26 % of the estimated full-year GDP. Overall, recent estimates of Iceland's net international investment position suggest a continued reduction in external indebtedness, but the level is still high. Risks and vulnerabilities with respect to Iceland's external financial position remain pronounced.

Table 1.1:
Iceland - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	1,2	-6,6	-4,1	2,7	1,4	2,3
Private consumption	Ann. % ch	-7,8	-15,0	0,1	2,6	2,4	1,2
Gross fixed capital formation	Ann. % ch	-20,4	-51,4	-9,4	14,3	5,0	-13,0
Unemployment	%	3,0	7,2	7,5	7,1	6,0	5,6
Employment	Ann. % ch	0,9	-6,2	-0,3	0,0	1,1	2,6
Wages	Ann. % ch	8,1	3,9	4,8	6,8	7,8	5,4
Current account balance	% of GDP	-24,6	-11,5	-8,0	-6,3	-5,5	-0,4
Direct investment (FDI, net)	% of GDP	30,5	-18,2	20,7	7,7	31,6	5,0
CPI, average	Ann. % ch	12,7	12,0	5,4	4,0	5,2	3,8
Interest rate (3 months)	% p.a.	15,84	11,28	6,79	4,26	5,51	6,18
Stock markets	Index	3.510	465	563	602	649	758
Exchange rate ISK/EUR	Value	127,58	172,15	161,62	161,20	160,75	162,45
Nominal eff. exchange rate	Index	135,2	98,1	100,0	100,0	97,6	97,95
General government balance	% of GDP	-13,5	-9,9	-10,1	-5,6	-3,8	-2,8
General government debt	% of GDP	70,5	87,9	93,0	99,1	96,4	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Labour market conditions continued to improve. For the year 2012 as a whole, the unemployment rate dropped to 6 %, from 7 % in 2011. The number of long-term unemployed was year-on-year 18 % lower in the first half of 2013. The share of long-term unemployed in total unemployed declined too, from 29 % in the fourth quarter to some 20% in mid-2013. Long-term unemployment accounts for about 1.1 % of the total labour force. Seasonally adjusted unemployment dropped to 4.7 % from 6 % the previous year. Employment rose in the first half by 1.6 % year-on-year, compared to 0.5 % a year before. Overall, the labour market has strengthened but the share of long-term unemployed and youth unemployment among total unemployed is still significantly higher than before the crisis.

Wage pressures continued to ease. Average real wages dropped by 0.6 % in the fourth quarter of 2012, as compared with a 3.6 % increase in 2011. However, due to rather high real wage increases in the first half of 2012, the annual average wage increase remained fairly stable at 2½ %. In the first seven months of 2013, the year-on-year rise in real wages remained lower than before, at some 1.6 %. Overall, despite a rather solid increase in real wages, employment growth remained rather strong.

Monetary and exchange rate policy was largely in line with Iceland’s economic situation. The Central Bank continued to officially operate under an inflation targeting regime to keep consumer price inflation under 2.5 % with a tolerance band of 1.5 % in both directions. Policy rates remained unchanged since November 2012 at 5-6 %. The Central Bank announced that further interest rate decisions would largely depend, among other things, on wage settlement agreements in late 2013 and early 2014. Annual inflation dropped from the 2012 peak of 6.5 % in April to 3.3 % during April to June, but rose again to 3.8 % and 4.3 % in July and August, respectively. The persistently higher than targeted inflation risks entrenching inflationary expectations at a rather high level. Bringing down inflation towards the Central Bank target remains a challenge.

Some further steps were taken to implement the capital liberalisation strategy, such as trying to reduce the stock of non-resident króna holdings, estimated at some 25 % of GDP. Once offshore holdings have been significantly reduced, it is planned to ease capital controls. In early 2013, the authorities deleted from the foreign exchange law the 2013 deadline for lifting capital controls. This should increase the incentive for offshore króna holders to sell off their ISK assets. Overall, some steps have been taken to prepare for the lifting of capital controls. However, progress has been very limited so far.

Fiscal policy remained geared towards fiscal consolidation. The 2012 deficit was further reduced to

3.4 % of GDP, but remained significantly above its initial target of 1.7 % of GDP. This loosening of fiscal ambitions reflected weaker-than-expected economic growth and the decision to increase spending, in particular on public sector wages, to accommodate rising wage demands largely driven by persistently higher-than-expected inflation. Nevertheless, the 2012 budget managed to reduce the deficit by 2.2 percentage points of GDP. In the first half of 2013, the annualised general government deficit was at around 2.9 % of GDP, compared to a deficit of around 2.7 % the year before. However, this points to difficulties in meeting the initial target of a largely balanced budget in 2013. Overall, despite continued fiscal consolidation, the speed of adjustment is behind target.

In view of the still highly uncertain global outlook and in particular given the new government's ambitious reform programme, risks to the fiscal consolidation strategy have increased. Furthermore, little progress has been achieved in strengthening Iceland's budgetary framework with a view to improving effective control of spending by government agencies. Contingent liabilities in the form of government guarantees for basically three public companies remain significant, amounting to some 77 % of GDP by end-2012. In view of the high level of public debt, fiscal space remains very limited. So far, capital controls have provided public finances with the benefit of artificially lower interest rates than could otherwise be expected in view of the level of indebtedness. Overall, fiscal risks have increased and expenditure-based fiscal consolidation remains a particular challenge.

Gross general government debt increased again in the first quarter of 2013 to 107 % of GDP, compared to 99 % in 2012 and around 30 % before the crisis. Further progress has been made in professionalising medium-term public debt management. The average maturity profile of the public debt portfolio was further extended to 6.4 years by the end of 2012, reducing rollover risks. The new medium-term debt management strategy (2013-16) plans to reduce central government debt to below 70 % of GDP by 2016 and to below 60 % in the long term. Overall, in view of the high level of public debt, the authorities have taken some steps to reduce refinancing risks.

The policy mix continued to focus on exchange rate stabilisation, fiscal consolidation, and domestic debt restructuring, which supported the recovery. However, the post-crisis recovery is not completed yet. Despite a reduction in annual inflation, current levels and expectations have remained above the Central Bank's target. Maintaining a largely stable exchange rate and proceeding with fiscal consolidation remain major challenges. So far, macroeconomic stabilisation has greatly benefited from capital account restrictions but the negative effects of those controls, such as lowering Iceland's attractiveness to foreign investors and limiting investment possibilities, are increasingly evident. Developing a strategy and proceeding with preparing the ground for the removal of capital controls remain key policy challenges.

Interplay of market forces

Private sector activities account for nearly 80 % of Iceland's value added. However, as a result of the crisis, the state has become an important player in the financial sector, maintaining nearly full ownership of one of the three market-dominant commercial banks and a minority stake in the other two systemic banks. Furthermore, the state has full ownership of the Housing Financing Fund and also of sectors such as energy production and transmission, postal services and broadcasting. It has also kept its position as a large investor in the savings banks system, although the importance of the system has declined significantly. There are currently no plans to privatise state companies in those sectors. Prices of goods and services continued to be mostly determined by supply and demand conditions, with the exception of agriculture, where the level of import protection remained high. Overall, market mechanisms are to a large extent driven by free prices. Public ownership remains significant in some sectors and there are no plans for privatisation.

Market entry and exit

Iceland's business environment has remained supportive of the country's economic recovery. In general, starting but also closing a company is facilitated by low bureaucratic hurdles and a generally efficient administration. However, high barriers to entry remain in place for fishing, agriculture and energy, which are not covered by the EEA Agreement. The continued economic recovery had a positive effect on company start-ups. In the first half of 2013 the number of new companies was about 8 % higher than a year before, compared to an annual increase of 3 % in 2012. However, total registrations are still markedly lower than before the crisis. Bankruptcy proceedings are generally straightforward. The crisis put a large part of the corporate sector under severe financial distress and insolvency levels in 2012 were still 50 % higher than before the crisis. In the first half of 2013, the number of insolvent companies was some 40 % lower than a year earlier, but was still significantly higher than before the crisis. Overall, despite generally low entry barriers, low bureaucratic hurdles and an efficient administration, significant barriers to market entry remain in key strategic sectors, such as fisheries. Market exit has been functioning well, supporting economic adjustment and structural change.

Legal system

The legal system continued to support an investment climate that is generally business-friendly, by providing comprehensive property registration, and good protection and enforcement of property rights. In principle, this clear, stable and transparent framework allows economic agents to take economic decisions in a situation of legal certainty. However, the existence of capital controls restricts the full use of property rights and uncertainties concerning the lifting of these controls remains.

Financial sector development

The financial sector made good progress with its post-crisis consolidation process. Private sector deleveraging and bank balance sheet repair continued. Household debt declined further to 109 % of GDP, as compared with its peak of 130 % in 2009. Corporate debt declined to 194 % of GDP, after peaking at 380 % at end-2008. However, private households and businesses still have limited access to fresh financing. The recapitalisation of the country's three systemic banks is largely completed, with an increase in the three banks' total capital adequacy ratio from 22 % at the end of 2011 to some 25 % in mid-2013, well above the minimum requirement of 16 %. The number of banks has decreased slightly. All banks are operating only at domestic level. The three largest commercial banks together with the Housing Financing Fund represent a market share of 92 %. The government retains nearly full ownership of one of the banks and minority stakes in the other two banks. No progress was made with privatising the state shares in the banking sector. All banks remained profitable, with returns on equity at 14 % at the end of 2012, compared to 7 % a year before. However, cost-to-income and cost-to-asset ratios are rather high, pointing to relatively low efficiency. Interest rates on deposits remain distorted by capital controls, providing a competitive advantage to domestic banks.

The share of non-performing loans continued to decrease significantly, from 23 % at end-2011 to around 10 % by mid-2013. On the funding side, banks continued to rely mainly on domestic deposits, since foreign direct investment and access to foreign credit remained limited, except for the sovereign. Overall, banking sector and debt restructuring has made good progress, but significant uncertainties remain with respect to banks' asset quality.

Some further progress has been made in strengthening bank regulatory and supervisory practices. In autumn 2012, new rules for liquidity coverage were adopted. Banks started to report this data in early 2013. Reporting of this data will become obligatory during 2013. However, after a strong increase in supervisory capacities, now the efficiency of those institutions needs to be strengthened, aligning Icelandic banking sector regulation with best international practices and standards.

The non-banking financial system mainly consists of the state-owned Housing Financing Fund, pension funds, insurance companies and mutual, investment and institutional funds. The Housing Financing Fund received another €81 million public capital injection, bringing its capital adequacy ratio to 3.2 % of risk-weighted assets. However, this is still far below the 5 % long-term target. Overall, efforts have continued to strengthen the shock resilience and prudential standards of Iceland's financial sector. Improving the sustainability of the Housing Financing Fund's operations remains a challenge.

Domestic equity markets regained some ground as channels of financial intermediation, after the heavy losses in the aftermath of the crisis. Turnover in the equity market rose by 29 % in 2012, compared to an increase of 20 % the year before. Market capitalisation increased to some 23 % of GDP at end-2012, compared to 20 % in mid-2012 and around 120 % of GDP before the crisis. The bond market, on the other hand, shrank in the second half of 2012, leading to a decline in the 2012 trading volume of 10.7 %, which brought the volume down to about 137 % of GDP. The market continues to be dominated by government and government-guaranteed bonds. Overall, domestic financial markets have somewhat recovered.

1.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Existence of a functioning market economy

After the boom-and-bust financial sector turbulences, the economy has made further progress in regaining a sufficient degree of macroeconomic stability, which would allow economic agents to make decisions in a climate of stability and predictability. The legal framework, law enforcement and institutional and administrative capacities are well developed. The financial sector has made further progress in addressing crisis-related imbalances. However, the efficient allocation of resources is still impeded by extensive capital restrictions, and high barriers to market entry for foreign nationals in some sectors. Overall, improving the functioning of financial markets by lifting the capital controls remains a particular challenge.

Human and physical capital

Iceland's economy benefits from a relatively highly educated labour force and a high labour participation rate. About 79 % of Iceland's working-age population were active in the labour market in the first half of 2013, which is high in international comparison, but slightly lower than before the crisis. Some 25 % of the population have completed tertiary education, and some 38 % secondary education. Even during the crisis, the authorities continued to allocate around 8 % of GDP to education, while private households bear only around 10 % of the total costs of their education. As a result of the crisis, skill mismatches appeared, which the authorities tried to address with additional training. Good skills and proficiency in foreign languages also facilitated outmigration during the crisis, which helped to reduce labour market pressure. Overall, Iceland is endowed with a relatively well educated, trained and flexible labour force.

Capital investment dropped markedly in the aftermath of the 2008 crisis and has not recovered since. In 2012 and the first half of 2013, investment accounted for only about 14.4 % and 13 % of GDP, respectively, close to historic lows. Private investment declined by 23 % in 2012 and by 19 % in the first quarter of 2013. Public investment declined by 17 % year-on-year in 2012, falling to only 1.8 % of GDP, compared to a long-term average of around 3.7 % of GDP. This decline in public but also private investment reflects the impact of the crisis, uncertainty concerning the global economy, but also to some extent the continued uncertainties with regard to Iceland's lifting of capital controls. As a result of the small size of the economy, capital investment tends to be volatile and is often

concentrated in a limited number of sectors, in particular capital-intensive energy-related investment projects or the fishing industry. Foreign direct investment amounted to 28 % of GDP in 2012, compared to 7.7 % the year before. The accumulated stock of FDI represented nearly 100 % of GDP in 2012, compared to 95 % the year before. Spending on R&D as a percentage of GDP is rather high, at around 3 % in 2012. Overall, the capital stock suffered from low private and public investment in the aftermath of the financial crisis. Investment is concentrated in a few sectors.

Sector and enterprise structure

The effects of the crisis have accelerated structural change, with a sharp increase in the share of tourism and transport and a decline in financial services. Some high-tech industries, such as software, pharmaceuticals and biotechnology, have gained in importance. However, Iceland’s economy continues to rely heavily on aluminium, fisheries and fish processing, accounting for roughly 30 % of the country’s value added and some 80 % of export earnings. Services account for two thirds of the economy and almost three quarters of employment. The importance of tourism has been steadily increasing, accounting for 28 % of total export earnings in the first half of 2013, a result of the 15 % increase in foreign tourism income since 2012. The share of marine products and primary aluminium products remained stable at 80 % of merchandise exports, while the share of services, mainly travel and transport, rose from around 35 % of total exports in 2011 to about 38 % in 2012. The importance of small and medium-sized firms in the economy remains significant, accounting for some 70 % of employment and output. Overall, post-crisis adjustment accelerated structural change. In particular tourism has gained in importance. However, Iceland’s overall degree of economic diversification is low.

State influence on competitiveness

The level of state subsidies remained at 1.7 % of GDP in 2012, largely reflecting continued government support for the relatively small agriculture sector through government subsidies, import protection, and a system of production quotas. Certain industries such as energy and fishing remain protected from foreign ownership. The telecommunication sector is liberalised and privately owned while government interventions remain limited to infrastructure investments in remote areas. Overall, the level of state aid is rather high and state participation remains significant in some areas, including the banking sector.

Economic integration and convergence with the EU

Iceland is a small open economy with total trade in goods and services representing around 112 % of GDP. Iceland’s trade integration with the EU is high, with more than 70 % of total exports in 2012 being shipped towards EU destinations, although the share dropped from 78 % a year before. The composition of exports is dominated by a limited set of products, in particular maritime products and aluminium. However, in late 2012 and early 2013 the trend towards strong growth in exports of services, i.e. tourism, continued. The import structure is more diversified, reflecting Iceland's dependence on a wide range of goods and commodities. Some 44 % of imports originate in the EU. FDI inflows originate almost exclusively from EU partner countries. However, after strong progress in the first decade of this century, investment integration has lost momentum, partly due to the effects of capital controls. Overall, integration with the EU in the areas of trade and investment remained high.

Average labour productivity improved slightly in 2012. However, wage increases were above productivity growth, which further pushed up unit labour costs by some 5.7 % in 2012, compared to a 4.7 % increase the year before. The exchange rate depreciated in 2012 by 6.6 % against the euro. It remained fairly stable in nominal effective terms, but appreciated slightly in real effective terms. According to estimates, the real exchange rate remains some 20 % below its pre-crisis average. Overall, Iceland still benefits from strong price competitiveness vis-à-vis its main trading partners.

1.3. CONCLUSIONS

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.

Iceland's economy continued to recover, albeit at a decelerating pace. So far, the recovery has been largely supported by private consumption, while investment remained weak. Low investment translated into low import growth, which helped to maintain a surplus in the trade balance and a largely balanced underlying current account. Record increases in tourist revenues largely compensated a weaker export performance. The labour market situation improved, leading to a significant reduction in unemployment. Nevertheless, unemployment among the young population and long-term unemployed remain a policy challenge.

Inflationary pressures subsided slightly in the first half of 2013. However, annual inflation is still clearly above the central bank's target of 2.5 %. Despite continued fiscal consolidation, the speed of adjustment has slowed down further. Fiscal risks persist due to spending pressures and sizeable contingent liabilities. Public debt levels remain high. Financial sector consolidation made progress, although debt restructuring of private households and companies is not completed yet. The efficiency of financial sector supervision is still not in line with international standards. In some sectors competition remained limited, either as a result of legal entry restrictions or of substantial state involvement, hampering investment and the growth potential of those sectors.

Capital controls continue to lead to distortions in the financial and capital markets and impede Iceland's investment climate and thus growth potential. Preparing a detailed strategy on how to lift these restrictions and proceeding with necessary measures, while preserving exchange rate stability remains a key challenge. An ad-hoc group on the removal of capital controls, including experts from the European Central Bank, the Commission and the International Monetary Fund was set-up in June 2012 at the request of the Icelandic government, within the framework of accession, to assess prospects for lifting these controls.

2. 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.

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Domestic consensus on the fundamentals of economic policies was broadly maintained, even though the parliament adopted the 2013 central government budget under controversial circumstances. Macroeconomic stability was preserved against the background of a continuously challenging external environment and high unemployment.

The 2013 Pre-accession Economic Programme (PEP) for the period 2013-2015 was submitted in January 2013 and outlines key economic, fiscal and structural policies and planned reform measures. The key objectives remain promotion of growth and employment. The World Bank accorded €155 million under the Public Expenditure Policy based guarantee programme in January 2013, to help the country secure a foreign commercial loan for the financing of the 2013 central government budget deficit. Cooperation with the international financial institutions continued as planned. The country's two-year arrangement under the IMF's Precautionary and Liquidity Line ended on 18 January 2013. *Overall*, a broad consensus on the fundamentals of economic policies was maintained.

Macroeconomic stability

The economy has gradually returned to growth, after the economic situation had deteriorated somewhat during 2012. The output declined by 0.2% in 2012, mainly due to lower private consumption and a worsening merchandise trade balance, while investment growth continued to be strong. The economy has recovered gradually since the third quarter 2012, and in the second quarter 2013 GDP growth reached 3.9% compared to a year earlier. This was carried by strong increases in investment, even though its growth slowed down, from an average 16% in 2012, to an average 8.2% in the first half of 2013. Private consumption contributed to growth in the second quarter, for the first time since the beginning of 2012, as did the trade balance, through strong exports of goods of newly established foreign investors. Encouraging signals emerged from industrial production, which increased by 2.2% in the first seven months of the year, compared to the same period a year earlier, after a 2.8% drop in 2012. Average per capita income in purchasing power standards stayed at 35% of the EU-27 level. *Overall*, the renewed growth of the economy remains narrowly based on investment, with only gradual strengthening of the external sector and also marginal support from private consumption.

External imbalances increased in 2012, with the difficult global environment leaving its mark on the current account deficit, which increased to 3.9% in 2012, up from 3% in 2011. This was mainly due to a widening merchandise trade deficit, which reached 24% of GDP. Its financing relied increasingly on foreign credit, as net foreign direct investment (FDI) inflows declined by about two thirds in 2012 to 1.4% of GDP, on account of large outflows of intercompany loans. Private transfers remained strong at some 21% of GDP, with the share of workers' remittances resilient. In the first half of 2013, FDI inflows picked up again, reaching 2.7% of GDP, 21% higher than in the same period a year earlier (how much). However, private transfers declined by 11% to about 18% of GDP.

Gross external debt rose to 65% of GDP at the end of the first quarter 2013, from 62% a year earlier. The increase was driven mainly by government external financing, which raised public external debt

to 27.3% of GDP, compared to 24.4% a year earlier. Private external debt, including intercompany lending, increased by 0.9 percentage points to 38.4%. The international reserve position weakened slightly. At the end of August, foreign reserves amounted to €2.1 billion or about 26% of GDP, compared to 30% of GDP a year earlier. The reserves covered about 4 months of prospective imports of goods and services, which is slightly less than a year earlier. *Overall*, there is at present limited risk to macroeconomic stability from the external side. The current account balance has been gradually improving with a pick-up in export activity, yet it is increasingly relying on foreign credit financing, with uncertain prospects for the development of private transfers.

Table 2.1:
The former Yugoslav Republic of Macedonia - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	5,1	-0,9	2,9	2,8	-0,4	3,4
Private consumption	Ann. % ch	7,4	-4,7	2,1	2,9	-1,2	0,3
Gross fixed capital formation	Ann. % ch	5,4	-4,3	-2,7	12,3	16,0	8,2
Unemployment	%	33,8	32,2	32,0	31,4	31,0	29,4
Employment	Ann. % ch	3,2	3,4	1,5	3,1	0,4	4,3
Wages	Ann. % ch	8,7	14,1	1,0	1,2	0,2	1,4
Current account balance	% of GDP	-12,8	-6,8	-2,1	-3,0	-3,9	-3,2
Direct investment (FDI, net)	% of GDP	6,1	2,0	2,2	4,5	1,0	1,2
CPI	Ann. % ch	8,3	-0,8	1,6	3,9	3,3	3,6
Interest rate (3 months)	% p.a.	5,30	N.A.	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	5.149	2.497	2.472	2.407	1.890	1.822
Exchange rate MKD/EUR	Value	61,26	61,28	61,51	61,53	61,53	61,63
Nominal eff. exchange rate	Index	100,6	106,6	106,0	106,9	108,3	108,6
General government balance	% of GDP	-0,9	-2,7	-2,5	-2,5	-3,8	N.A.
General government debt	% of GDP	20,7	23,8	25,8	28,4	34,0	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment remained persistently high, in particular youth and long-term unemployment, pointing to deep-rooted structural impediments in the labour market. There was some gradual improvement in the official employment and unemployment rates. In June 2013, total unemployment stood at 28.8% of the labour force, having declined by 2.4 percentage points compared to a year earlier. For workers aged 15 to 24 years, the unemployment rate reached 51.7%, down from 54.9% a year earlier. The employment rate increased to 40.7%, compared to 38.8% a year earlier. The recorded employment creation derives to a large part from an increase in part-time and self-employed occupations, and from a rise in public sector employment. *Overall*, in spite of some incremental improvement in the official labour market figures, labour market policy had limited success in addressing the persistently high unemployment. Structural challenges in the labour market remain to be tackled.

Monetary policy remained consistent and adequate given the economic environment and the situation of the domestic banking sector. The exchange rate policy and the de facto peg to the Euro continued to be an integral part of the central bank's strategy targeting price stability. In order to support the economic recovery and combat sluggish credit growth, the central bank relaxed monetary conditions at several occasions since the beginning of 2013. It lowered two key policy rates: the maximum rate on central bank bill auctions, from 3.75% to 3.25%; and the 7-day deposit rate, from 2% to 1.50%%. The interest rate on overnight deposits was reduced from 1% to 0.75%. It also eased reserve requirements for loans to net exporters and to energy producers. Consumer price inflation was markedly higher than a year before, with an average inflation in the first eight months of 2013 of 3.5%, compared to 2.5% in the same period a year earlier. Higher prices for electricity and food, but also higher administrative prices were the main drivers bringing year-on-year inflation to above 4% in the last months of 2012. As of July, regulated electricity prices for households were lowered. With energy costs abating, more recent inflationary pressures derived mainly from domestic factors, in

particular adverse climate conditions impacting on food prices. *Overall*, monetary policy remained stability-oriented. Energy costs and food prices were the main drivers of rising inflation.

Fiscal discipline was relaxed in 2012, and the quality of public spending deteriorated further. The general government budget deficit reached 3.8%, thus overshooting even the revised deficit target, which the authorities had raised by 1 percentage point to 3.5% in autumn. Another budget rebalancing reduced mainly investment spending, due to severe revenue shortfalls. Total expenditure as share of GDP rose from 31% in 2011 to 34% in 2012, and is estimated to reach 35% in 2013. The primary government budget deficit rose to 3.1% of GDP in 2012, compared to 1.7% in 2011. Capital spending was almost unchanged in 2012 compared to 2011, at 12% of total expenditure, or just over 4% of GDP, projected to decline to 11.3% of total expenditure in 2013, or 3.9% of GDP. The share of social transfers in total expenditure declined slightly in 2012, to 44.7% from 45.2% a year earlier, and is projected to stay largely unchanged in 2013. As a share of GDP, social transfers increased somewhat, to 15% of GDP, up by 0.4 percentage points.

The 2013 budget foresees a slight reduction in the deficit, to 3.5%, based on rather optimistic expectations of strong growth of revenues, which are projected to be 7.2% higher than in 2012. Yet, after the first seven months of 2013, the central government budget deficit amounted to over 80% of the targeted full-year deficit. This was mainly on account of repayment of arrears in VAT returns, contracted works, and social benefits, which led to an increase in expenditures in the first seven months of about 6% compared to the same period 2012. The government started settling the outstanding amounts as of September 2012.

Even though government debt is still at a moderate level, the increases over the last years give rise to concern. Central government debt stood at 33.6% of GDP by the end of July 2013, compared to 27.8% at end-2011. Moreover, as the budget of the newly created public enterprise for state roads was excluded from the central budget as of 2013, its debt is no longer included in central government debt. *Overall,* fiscal governance and fiscal discipline deteriorated and would benefit from the implementation of a medium-term strategy.

The policy mix slightly deteriorated. While monetary policy provided key support for macroeconomic stability, fiscal discipline weakened and the debt ratio further increased. Public finance could make a bigger contribution to stability, for example by better aligning spending priorities with structural challenges, and by focusing on growth-enhancing capital expenditure. Furthermore, the fast rise in mainly foreign financed debt increases the country's vulnerability.

Interplay of market forces

The role of the public sector in the economy remained largely unchanged. In terms of value added, the private sector accounted for about 85%, as in 2012. The asset value of fully or partly state-controlled enterprises increased to 15.7% of GDP in mid-2013, compared to 12.7% a year earlier, due to capital increases in public companies. The number of fully-owned state companies increased from 12 to 15, due to restructuring in the public sector. The majority of state capital is concentrated in five companies, which are mainly public utilities. The share of public sector employment in total employment remained stable at about 25%. Administered and regulated prices continued to account for some 13% of the Consumer Price Index (CPI) basket. In general, regulated prices, which account for about 12% of the CPI basket, usually cover costs, while administered prices, such as for water supply and waste disposal, usually do not fully cover costs. *Overall*, the economy is mainly driven by the private sector, with the role of the state remaining limited, even though share of the public ownership increased slightly.

Market entry and exit

The business environment was further improved through the simplification of business registration and operation, for example by the establishment of a one-stop shop system for domestic and foreign investors. While companies enjoy a low level of taxation, corporate liquidity suffered in 2012 from the accumulation of government arrears for VAT refunds and contracted works. Implementation of the third (reduction of administrative burdens) and fourth phase (SME measures) of the ‘regulatory guillotine’ project continued, and procedures for obtaining construction licenses were simplified.

There has been more limited progress on reforming market exit procedures. The deletion from the central registry of companies that were not operational for a long time has started. However, improving exit options through facilitated bankruptcy procedures proves more challenging. In May 2013, an amendment to the Law on Bankruptcy was adopted, which foresees an acceleration of proceedings. Yet, the number of bankruptcy procedures between October 2012 and July 2013 was lower by 29% compared to a year earlier. The average duration of voluntary company liquidation diminished only slightly. *Overall*, while business registration and operation was further facilitated, weaknesses in bankruptcy and liquidation procedures continue to pose a significant impediment to investment and access to finance.

Legal system

The legal system was further strengthened in some parts, notably the clearance rates of courts at all levels improved and there are no significant backlogs remaining. However, the overall duration of court proceedings remains a concern. The registration of real estate property is finalised and the land register covers 100% of the country’s territory. The authorities implemented a number of reforms to reduce the work load of courts, in particular through the transfer of enforcement cases to private bailiffs. While the legal and financial independence of some regulatory and supervisory bodies has been further strengthened in formal terms, the impact on the business environment has remained limited. Institutional and administrative capacities, such as insufficiently skilled human resources and insufficient physical resources continue to hamper the proper functioning of some of these agencies like the State Appeals Commission for Public Procurement and the State Audit Office. *Overall*, the legal system for a functioning market economy is largely in place, yet weaknesses related to lengthy procedures, contract enforcement and corruption remain.

Financial sector development

The economic weight of the banking sector remained stable, with total assets of commercial banks amounting to about 87% of GDP. The sector remains highly concentrated, with two thirds of total assets owned by the three largest banks, the biggest bank alone accounting for about a quarter of total assets.

Liquidity and solvency of the banking sector proved resilient to the subdued global economic and market environment. The average ratio of liquid to total assets improved throughout 2012, and stood at 29.6% at the end of the first quarter 2013, compared to 26.5% a year earlier. Liquid assets cover just over half of household deposits, slightly less than a year earlier. Regulatory capital in relation to risk-weighted assets stood at a comfortable 17.3% at the end of the second quarter.

The credit growth continued to decelerate. Annual growth of credit to the private sector has been declining since May 2012 reaching 3.5% at end-July 2013. Growth was driven almost entirely by loans to households, which increased by 7.8%. Credit growth to corporates declined to 0.5%, against the backdrop of a further deteriorating quality of corporate loan portfolios. The share of non-performing loans (households and corporates) in total loans stood at 12.3% at the end of June 2013, compared to 10% a year earlier, with the largest share accounted for by corporate loans. Given the

easing of monetary policy earlier this year, it appears that impediments to faster credit growth lie outside the transmission mechanism of monetary policy, and are possibly rooted in a combination of strong adverse risk perceptions of lenders, and a lack of quality investment projects on the demand side. In spite of the deteriorating portfolio quality, banks managed to avoid significant losses in profitability. Performance was somewhat weaker in the second quarter 2013 than a year earlier, as manifested by the decline in the return on assets (0.2%, compared with 0.4% a year earlier) and in the return on equity (1.8% compared with 3.2%). Lending in foreign currency decreased somewhat, but still accounts for close to 40% of total loans outstanding, which poses a potential stability risk given the de facto currency peg.

The relevance of non-banking financial intermediaries is generally low, at just over 10% of total sector assets, or 8% of GDP. Pension funds hold just over 4% of total assets and experienced strong asset growth in the reporting period. Assets in the mandatory fully funded pension insurance grew by 30% between February 2012 and February 2013, and those of the voluntary fully funded pension insurance by about 66%. The insurance sector continued to account for less than 4% of total assets. 4 new insurance brokers and 3 new agencies entered the market in 2012. While gross written premiums increased by over 3%, their share in GDP was almost unchanged, at over 1.4%, compared to 2011. The insurance sector remained well capitalised, solvent, and even improved its technical provision coverage from 96% in 2011 to 103%. *Overall*, the financial sector remained well capitalised and liquid. However, credit growth was sluggish and non-performing loans increasingly pose a challenge.

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

Existence of a functioning market economy

While persistently high unemployment points to serious difficulties to the functioning of the labour market, overall macroeconomic stability has been maintained. The quality of public finance planning and management has deteriorated further, with productive investment remaining below needs. Market entry procedures have improved, while the reform of market exit procedures still needs to gain pace. Enforcement of contracts remains difficult, which impacts negatively on the business environment.

Human and physical capital endowment

Further steps were taken towards improving the infrastructure and the quality of education at all levels, such as the recruitment of about 250 additional teachers for primary and secondary schools for the academic year 2012/13; investment in the education infrastructure; and a reinforced focus of secondary school curricula on entrepreneurial skills. Yet, the general qualification of the workforce remains low, and matching the skills of graduates with the needs of potential employers remains a major challenge. A strategy for vocational training reform was adopted, and practical experience during education was made mandatory. There was little progress in implementing the adopted reforms.

The country's capital stock remains low and relatively outdated given the underinvestment of the past. Gross fixed capital formation was strong in the last quarter of 2012, at 36% of GDP, partly due to a boost in public capital spending, but fell to 26% of GDP in the first half of 2013. Public investment stayed at over 5% of GDP in 2012. It was concentrated on transport and utilities infrastructures, with some investment also in the physical infrastructure of education. Its impact on growth and employment is, however, difficult to assess due to lack of recent disaggregated data and implementation details. Spending is not sufficiently focused on building a knowledge-based society, but is used for less productive purposes, such as the decoration of the capital. Weak implementation capacity continues to impede the authorities' efforts to add to, and to modernise the public capital

stock. Foreign direct investment, which in the past was more evenly distributed among manufacturing and services sectors, shifted towards more traditional manufacturing sectors recently. The stock of foreign investment amounted to just below 50% of GDP in mid-2013, down from 53% a year earlier. Overall, there was some gradual progress in addressing reform needs in the education system. The capital stock remains modest and public spending was not sufficiently focussed on growth-enhancing activities.

Sector and enterprise structure

In 2012, the economic activity shifted slightly from the industrial sectors to services activities. The share of the mining, manufacturing and utilities sectors in total value added declined from 21.3% in 2011 to just under 20% in 2012, while the share of financial and community, social and personal services rose from 18.9% to 19.6%. The enterprise structure remained largely unchanged in 2012. The share of SMEs (national definition) in total private sector employment increased slightly compared to 2011. Access to finance was eased somewhat by the use of the credit line from the European Investment Bank. However, SME development continues to be impeded by poor access to financing. Competition in the network industries remains constrained by the small number of incumbent suppliers. In spite of some improvements in employment registration, the informal sector remains sizeable and poses a challenge for policymakers, as it reduces the tax base and the efficiency of economic policies. *Overall,* the enterprise structure remained largely unchanged, with further SME development hampered mainly by difficult access to finance. There has been limited progress in tackling the large informal sector.

Some further progress towards diversification into manufacturing activities with higher value added is evidenced by the export structure, partly reflecting the new operations of a few foreign investors. The share of machinery and transport equipment in total exports amounted to 9.9% in 2012, an increase by 2 percentage points compared to 2011. Still, clothing, chemicals, and manufactured iron and steel products account for almost half of exports. Overall, in 2012, 70% of total exports were accounted for by 15 products. *Overall,* some gradual, further diversification of economic production is visible in terms of value added and exports.

State influence on competitiveness

Government's influence on the economy's competitiveness remains limited and is mainly exerted through direct subsidies to and tax exemptions for companies, including in particular foreign investors, and through active labour market programmes. Official data points to a decline in state aid in 2012 to about 0.1% of GDP, from about 0.4% in 2011. Reporting on state aid and comparability with EU standards remain limited. The legal framework for state aid was strengthened by the adoption of regulations on regional aid, horizontal aid and Services of General Economic Interest. Yet, their impact remains limited given the low reporting awareness in state aid providers. *Overall,* while state aid laws have been strengthened, there is a lack of transparency about implementation details and amounts due to shortcomings in reporting.

Economic integration and convergence with the EU

The country's total trade in goods and services remained largely unchanged in 2012, at about 128% of GDP. Trade integration with the EU progressed further: over 73% of total exports were destined to the EU in the first half of 2013, compared to 65% a year earlier. FDI from the EU accounts for close to 80% of total FDI stock, with the Netherlands, Austria, Slovenia and Greece as the biggest foreign investors, providing over half of the total foreign investment stock. Labour productivity declined by 1% in 2012. Price competitiveness also remained broadly unchanged: the real effective exchange rate, adjusted by the consumer price index, appreciated slightly, on average, by about 0.2 percentage points. Wage developments were not conducive to a pick up in private consumption: in the first

quarter 2013, real net wages dropped by an average 2.3% on the year. *Overall,* trade integration with the EU is quite advanced. The export structure continues to improve, even though traditional manufacturing products still dominate. International price competitiveness remained largely unchanged.

2.3. CONCLUSIONS

In terms of the economic criteria, the country remains well advanced and, in some areas, has made further progress towards becoming a functioning market economy. 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 programmes in order to reduce significant structural weaknesses.

Economic activity stagnated in 2012, with growth resuming in the first half of 2013. Against the background of a challenging external environment, macroeconomic stability was preserved. Unemployment remains very high, especially among young people. The rising deficit and public debt levels increased the country's vulnerability.

Measures need to be undertaken in order to address the underlying reasons for the high unemployment, in particular tackling the skills mismatch. The sustainability of public finances needs to be strengthened. Fiscal policy needs to be aligned with the country's structural reform priorities and oriented towards growth enhancing spending. The introduction of a medium term fiscal framework and strategic planning would contribute to strengthening fiscal discipline. Further efforts are needed to effectively implement public financial management, in order to ensure the most efficient and transparent use of public and EU resources. To secure more private sector investment, further efforts are needed to improve the business environment, which is negatively affected by corruption, as well as lengthy and costly market exit procedures. The informal sector remains an important challenge.

3. MONTENEGRO

In examining economic developments in Montenegro, 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

In January 2013, the country presented its second Pre-accession Economic Programme (PEP), covering the period 2013-2015. The priority is still to strengthen fiscal and financial stability as a prerequisite for long-term economic growth. *Overall*, the political consensus on market economy fundamentals and economic policy was broadly maintained.

Macroeconomic stability

After two years of moderate growth, the economy entered into recession in 2012. Real GDP contracted by 2.5%, pulled downward by the poor performance of industry, construction, transport, financial services and agriculture. Industrial production contracted by 7% year-on-year, driven by the decline in manufacturing, particularly the metals industry. On the expenditure side, private consumption and investments remained weak, due to stagnant disposable income and the decline of construction works. Net exports had a positive impact on growth with stronger tourism partly compensating for the fall in merchandise exports (-18% year-on-year). The average per-capita income in purchasing power standards represented 42% of the EU-27 average in 2012.

The economy came out of recession in 2013 with real GDP expanding by 1.1% in the first quarter of 2013, and by 3.4% in the second quarter thanks to the positive performance of industrial production, and notably utilities. Other sectors, like construction, forestry, transportation, and retail trade recorded annual expansion but their overall contribution to growth remains limited. GDP growth slowed somewhat in the second quarter of 2013. In the first half of 2013, industrial output grew by 10.4% year-on-year, maintaining a similar pace in July and August too. In the first six months of 2013 the value of finalised construction works recorded 1.8% annual growth, and the number of tourists increased by 4% year-on-year, supporting 6.5% year-on-year increase of retail sales. However, private domestic demand still remains subdued due to the contraction of wages, low credit and a stagnant labour market. *Overall*, growth has been largely driven by external demand and one-off base effects, compensating for a still weak domestic demand.

In 2012, the merchandise trade deficit widened to 44% of GDP from 40.4% of GDP a year before. The increase in tourism revenues and higher surpluses from transfers of Montenegrin workers abroad did not suffice to fully compensate for the expansion of the trade deficit. As a result, the 2012 current account deficit 19% of GDP. In the four quarters to June 2013, the current account deficit narrowed to some 16% of GDP as the aggregated balances of services, current transfers and income were in surplus while the trade deficit contracted as a result of the improvement in the energy balance. In 2012, after two consecutive years of contraction, net foreign direct investment (FDI) climbed by 16.6% year-on-year to 14.7% of GDP. In the four quarters to June 2013, net FDI totalled 14.2% of GDP. Net errors and omissions remain a substantial source of finance, related to unrecorded revenues from tourism, remittances and other unregistered cash payments totalling 7.7% of GDP in 2012. *Overall*, despite some improvement, external imbalances still remain very large.

Unemployment remains very high at nearly 20%, practically unchanged since 2010 according to the Labour Force Surveys. In 2012, labour market participation improved marginally to 50% compared to

49% a year before. Regional disparities are significant. In the coastal and central regions, the unemployment rate is 10% and 15.6% respectively, but it rises to 36.7% in northern Montenegro. At national level, both the number of employed and the number of unemployed persons increased by 2.6% year-on-year in 2012. Long-term unemployment remains a serious concern, since 68% of unemployed persons have been out of work for more than two years. Unemployment particularly affects the young (15-24 years), who account for more than 40% of the total. Poor labour market dynamics have also been reflected in wage moderation. Average gross wages contracted in real terms by 3% in 2012 and by 1% in the first half of 2013. *Overall*, a poorly performing labour market with low participation and high unemployment rates, particularly among the young and the long-term unemployed, remains a serious challenge.

Table 3.1:
Montenegro - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	6,9	-5,7	2,5	3,2	-2,5	2,3
Private consumption	Ann. % ch	N.A.	-12,9	2,0	4,2	-3,2	N.A.
Gross fixed capital formation	Ann. % ch	N.A.	-30,1	-18,5	-10,3	-3,3	N.A.
Unemployment	%	16,8	19,1	19,7	19,7	19,7	19,2
Employment	Ann. % ch	6,3	4,8	-7,1	0,8	2,1	5,1
Wages	Ann. % ch	N.A.	2,3	10,5	-2,1	-3,3	-1,0
Current account balance	% of GDP	-49,8	-27,9	-23,0	-17,7	-18,7	-16,6
Direct investment (FDI, net)	% of GDP	18,9	35,8	17,5	12,0	14,7	14,2
CPI	Ann. % ch	7,4	3,4	0,5	3,1	4,1	2,2
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	2,27	5,32	3,34
Stock markets	Index	19.947	13.303	13.993	11.896	9.091	9.784
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	-0,4	-5,7	-4,9	-5,4	-5,6	-1,9
General government debt	% of GDP	29,0	38,2	40,9	45,9	54,0	53,6

Sources: Thomson Reuters/Ecowin, Eurostat

Unilateral euroisation implies that there is limited scope for monetary policy discretion. Changes in reserve requirements remained the key tool for steering liquidity in the financial system. The Central Bank of Montenegro (CBM) did, however, test the scope for curbing lending interest rates in November 2012. Rates on new corporate and household loans were capped, during a six-month period, at 14% and 15% respectively. The measure mostly provided relief for those new property or tourism investment loans whose rates were above these thresholds. Yet, the CBM decided not to renew the measure. At aggregated level, the weighted average lending interest rate contracted moderately, from 11.3% in October 2012 to 10.3% until June 2013.

Average consumer price inflation accelerated somewhat to 4.1% in 2012 compared with 3.1% a year earlier, on the back of administrative price increases for electricity and water as well as higher or new excises on tobacco, alcohol, carbonated drinks and coffee. Inflationary pressures eased in the first six months of 2013 as consumer disposable income contracted due to a personal income tax hike in February 2013. The consumer price index declined further to 2.2% in June, down from 3.9% a year before, as a result of the deceleration of prices of housing (which includes utilities), alcoholic beverages and tobacco, transport, as well as restaurants and hotels. In July, when the upper VAT rate was increased, CPI inflation accelerated to 2.7% year-on-year, but declined again to 2.2% in August. The impact of the VAT hike on inflation remained marginal as the tax increase did not apply to items benefitting from the reduced rate (i.e. some 50% of the consumer basket). *Overall*, inflation remains moderate.

In 2012, despite fiscal consolidation efforts, the government had difficulties meeting its budgetary targets. The budget deficit remained high, at 5.6% of GDP, considerably higher than the deficit target

of 2.4% GDP, reflecting weaker than expected growth together with the activation of state guarantees and the accumulation of tax arrears. General government spending broadened to 47% of GDP, from 45% a year before representing a substantial deviation from the planned figure of 41%. Social security transfers increased moderately (by 0.7%) driven by the increase in military pension beneficiaries, while public sector gross wages decreased marginally.

In the first half of 2013, the government pursued fiscal consolidation through a set of new fiscal measures, including a freeze on pensions and limits on salary increases for public enterprises and members of the parliament. Revenue measures consisted of increases of the personal income tax rate from 9% to 15% for salaries above the national average, and as of July, of the upper VAT rate. In the first half of the year, total revenue grew by 5.3% year-on-year, supported by accelerating economic activity, higher tax rates and more efficient collection, while saving measures reduced expenditures by 5.2% year-on-year. As a result, the general government deficit fell to 1.9% of annual GDP, compared with 3.9% in the same period a year before. The stock of cumulated tax arrears since the outbreak of the crisis is estimated at some 11% of GDP.

In July 2013, prompted by the Finance Ministry, the Commercial Court launched bankruptcy proceedings for the aluminium factory KAP. The government took over some of KAP's debts totalling some 3% of GDP, when two state guarantees were called. The Ministry of Finance managed to postpone parts of the debt payment to 2014. In view of strengthening fiscal discipline the government proposed in July 2013 a budget and fiscal responsibility law (i.e. fiscal rules), setting upper limits for public debt and budget deficit at 60% and 3% of GDP respectively. The bill, which is yet to be adopted by parliament, also foresees an independent fiscal council (within the existing state audit institution) to evaluate the government's economic policy and report to the parliament. *Overall*, fiscal risks remain high. The fiscal position of the government remains challenged by substantial contingent liabilities and growing debt.

In 2012, the public debt increased to 54% of GDP. External indebtedness expanded by 22% year-on-year in 2012 and accounts for three quarters of total public debt. State guarantees amounted to an additional 12% of GDP at the end of 2012. The public debt climbed to 52.5% in August following the activation of KAP's state guarantees. Given the shallowness of the domestic financial markets, Montenegro largely relies on foreign markets to finance its debt. *Overall*, roll-over needs keeps rising, together with the risks related to dependence on foreign investor sentiment.

The limited scope for monetary and exchange rate policies and the country's vulnerable external situation imply a strong role for fiscal and structural policies in safeguarding macro-financial stability. In that sense, the recent efforts to strengthen fiscal consolidation represent a further step to improve the policy mix. However, ensuring fiscal sustainability, coping with a weak external position, and public debt reduction, especially after the KAP bankruptcy, remain major challenges.

Interplay of market forces

In 2012, the state had majority ownership in some 30 companies, some of them in the process of liquidation or bankruptcy. The most important ones are concentrated in network industries and the aluminium-bauxite conglomerate. The tenders for the dairy Zora and part of the agricultural company Montepranzo were successfully closed. However, the sales of the publishing house Pobjeda and the institute for physical therapy failed. The government renegotiated, and in two cases cancelled, the sales contracts of hotels whose new owners failed to invest in them. Some companies, like Montenegro Post and a few attractive state-owned tourist resorts, are being successfully developed as concessions under public-private partnership schemes. *Overall*, the privatisation process, while relatively advanced, suffered some setbacks due to unsatisfactory investors' offers and some cancellations due to failures in post-privatisation investment.

In 2012 fuel prices were removed from the list of administered prices and their aggregated weight reduced in the harmonised index of consumer prices basket to 5.5%, from 10.7% a year before. At the beginning of 2013, the domestic energy market was further opened after the liberalisation of prices for large industrial consumers. In 2013, the weight of administrative prices in the consumer basket was revised upwards to 7.4% after electricity and bread were given greater weight in the annual household budget survey. *Overall*, the influence of the state in price dynamics remains limited.

Market entry and exit

In 2012, 3 540 new businesses were registered, or 6.5% less than in 2011. However, a more favourable environment in the first half of 2013 reversed the trend, with new registrations rising to 2 367, or 21% more than in the same period a year before. Montenegro has made some improvements in terms of the environment for starting a business. After the introduction of electronic business registration in May 2012, further measures to facilitate registration were implemented at regional level too. An electronic portal was opened to simplify procedures for granting business licences and to reduce the cost of and the time required for obtaining permits. In spring 2013, the parliament adopted amendments to the law on spatial planning and construction, shortening deadlines for issuing construction permits, increasing the number of 'objects of public interest' exempted from communal fees and utility charges during construction, and introducing government oversight of municipal fees. Concerning market exit, in 2012 the number of liquidations totalled 1 894, declining 9.4% compared to 2011. However, in the first half of 2013 the number of liquidations rose to 1 067, increasing by 25% year-on-year. The time to clear bankruptcy is estimated at two years, with a recovery rate of 43%. *Overall*, procedures for market entry were further simplified, while some limited progress has been achieved in making bankruptcy proceedings less cumbersome.

Legal system

Judicial proceedings, in particular to enforce commercial contracts, are reported to be slow and burdensome. Some progress has been made on simplifying government legislation and using regulatory impact analysis. After the introduction of a 'regulatory guillotine' in 2012, less than half of the relevant recommendations have been followed so far. In order to streamline caseload, the parliament adopted a law on out-of-court enforcement of commercial contracts by bailiffs. However, the implementing legislation for it is not complete. A land register is in place but modernisation of the land registry is still under way. The Tax Administration is tackling the informal economy mostly by stepping up surveillance of undeclared economic activities. In June 2013, the law on prevention of illegal business came into force. To prevent tax evasion, the law limits cash transactions (including for salaries), increases banks transparency on money transactions, and prohibits the establishment of new business for owners of companies undergoing bankruptcy proceedings. *Overall*, further efforts are required to improve the legal system and tackle corruption with the aim of improving the business environment.

Financial sector development

The withdrawal of foreign parent bank funding from Montenegrin bank deposits abated towards the end of 2012 thanks to calmer financial markets and stronger deposit growth (9% year-on-year in 2012 and in the first half of 2013; compared to 1.5% in 2011). In 2012, the guarantee for banks deposits was raised from €35 000 to €50 000. After several years of contraction, bank lending started to grow in 2013, expanding by 4.6% year-on-year in the first half of the year. The ratio of non-performing loans (NPL) increased to 16.9% of total loans at the end of 2012 compared with 15.5% a year earlier. At the end of 2012, loan-loss provisions covered 40% of NPLs, which net of provisions represented 68% of banks' capital. Following the introduction in January 2013 of international accounting standards (IAS/IFRS), loans previously recorded as losses are required to be transferred back onto the

banks' balance sheets. In the first half of 2013, the NPL ratio worsened, reaching 18.5% at the end of June.

Following the central bank's recommendations resulting from the stress tests performed in 2012, three banks raised their capital by the end of the year. However, at the end of 2012 the aggregate capital of commercial banks fell by 5.4% year-on-year as lenders wrote off losses. Consequently, the capital adequacy ratio (CAR) declined to 14.7% at the end of 2012 compared to 16.5% a year before. In the first six months to June 2013, bank's capital expanded by 4%, improving the CAR to 15.5%. Some 83% of banks' capital remains foreign-owned and 2.7% in public ownership. Banks' return on assets and on equity remained negative in 2012, at 2.1% and 18.3% respectively, reflected in the negative profitability of the financial sector in 2012, with an aggregated loss of €56 million compared with a €3 million loss a year earlier. The rebound of economic activity in the first six months of 2013 conveyed positive return on assets and on equity of banks (1.3% and 9.2% respectively), along with an aggregated profit of €18.5 million. *Overall*, the banking sector continues to deleverage, increasingly relying on deposits to fund their loans. The high level of non-performing loans still weighs on credit supply, constraining investments and growth.

The domestic non-bank financial sector remains shallow. The insurance segment recorded 3.2% annual growth in 2012, supported by government subsidies on insurance for agriculture. Insurance companies' gross premium represents some 2% of GDP. Non-life insurance continues to dominate its product structure with a market share of 86% compared with 14% for life premiums. Leasing contracts offer an aggregated value of around 4% of GDP. However, most of these contracts (97%) are for the purchase of vehicles rather than productive equipment. The stock exchange's annual turnover fell by 44.6% to €32.7 million in 2012, after increasing by 7.6% to €59 million a year earlier. *Overall*, the small size of the domestic financial market makes the country highly dependent on external financing, and therefore, vulnerable to shifts in market conditions.

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

Existence of a functioning market economy

Macroeconomic stability was broadly preserved. The country came out of recession in 2013 driven by external demand. Domestic demand remains subdued and the unemployment rate high. Credit started to slowly flow back into the economy, but the high level of non-performing loans still weigh on bank capitalisation and hence, on credit supply. External imbalances, albeit declining, still remain very high. The government pursued further fiscal consolidation measures. However, the fiscal position weakened burdened by substantial liabilities from the bankrupt aluminium industry.

Human and physical capital endowment

Employers complain about the lack of university graduates with the right set of skills. However, further reform of the education and vocational training systems has been delayed due to budgetary constraints. So far, government efforts are focused on subsidies for employers to recruit those with more difficulties into the labour market as well as young graduates without working experience. The large number of workers in early retirement remains a particular issue for the sustainability of public finances. *Overall*, more efforts are needed to promote skills in order to build the capacity of businesses to meet international competitive pressure.

A substantial part of investment in infrastructure is funded externally through FDI and international financial institutions. Work on the power transmission line for the interconnection project with Italy started in 2013 and will develop the local and regional electricity markets. The construction of several

small hydropower plants is under way, and in June 2013, a tender for additional concessions on eight watercourses was launched. Work on two wind power plants has been delayed pending the release of the urban plans. In July 2013 the Podgorica-Niksic railway line, linking the two largest cities together with the steel factory and bauxite mines to the port of Bar, was reopened after several years' closure for upgrading. In the tourism sector, the second phase of Porto Montenegro and work in Lustica peninsula and Kumbor are ongoing. *Overall*, capacity increase in transport, energy, and tourism sectors are setting the basis for future exports and overall growth performance.

In 2012, gross expenditure on research and development (R&D) represented some 0.4% of GDP, roughly the same as a year before. The private sector accounts for barely 27% of this figure. *Overall*, although public institutions participate actively in European research programmes, private sector involvement remains limited (*See Chapter 25 — Science and research*).

Sector and enterprise structure

The development of a regional electricity market is under way, and includes preparation of the interconnection infrastructure between the Italian and Balkan peninsulas through Montenegro and new connections between regional power systems, increased capacity and the establishment of the South-East European Coordinated Auction Office in Podgorica. In May 2013, the government signed a memorandum of understanding with Albania, Croatia and Bosnia and Herzegovina as a preliminary step towards developing a domestic gas market connected to the Ionic-Adriatic pipeline. The postal market has been formally liberalised. The restructuring of Montenegro Airlines is being implemented before re-listing the company for privatisation. The future of the aluminium industry remains uncertain. The company is bankrupt and (if accepted) a restructuring plan would still require substantial investment and subsidies. *Overall*, Montenegro's industrial structure is shifting from aluminium towards energy. At the same time, the overall structure of the economy is shifting towards services. In 2012, a breakdown of average employment by sectors showed 76% of workers to be employed in services, of which 24% were employed in wholesale and retail trade. Industry accounted for 18% (with 7% in manufacturing, 6% in construction, 2.4% in utilities and 1% in mining), and agriculture (including forestry and fishing) 5.6%. *Overall*, the expansion of the service sector is mostly in the non-tradable sector.

Small and medium-sized enterprises (SMEs) find it difficult to access credit. Public-sector support for SMEs remains limited. The value of financial relief provided by the state Investment and Development Fund (IDF) to SMEs in 2012 was €14 million. The IDF also provides some credit lines for start-ups and factoring facility. Some public support is also available to organise public export promotion programmes, including participation in trade fairs, trade missions and market research studies.

The informal sector is large and is fuelled by weaknesses in tax and expenditure policies and in law enforcement, including the fight against corruption. In an effort to reduce the informal economy, the government strengthened controls on excise goods, retail trade records and the labour market. *Overall*, credit constraints and unfair competition from the large informal sector remain major challenges for the development of SMEs.

State influence on competitiveness

In 2012, the government allocated €42 million or 1.3% of GDP in state aid, of which 84% was allocated to Montenegro Airlines. Yet, the state aid report does not cover the support to KAP for the supply in electricity, state guarantees or tax arrears. Parliament's decision in April 2013 to keep loss-making KAP going implies that state aid would continue until the company is thoroughly restructured or liquidated. Under the Stabilisation and Association Agreement and EU competition rules, any state aid must be temporary and accompanied by compensatory measures, and depends on a restructuring

plan ensuring the long-term viability of the company. *Overall*, state aid has been largely concentrated on two companies: KAP and Montenegro Airlines.

Economic integration and convergence with the EU

In 2012, Montenegro's trade openness fell by 4% to 69% of GDP, due to the contraction of exports. Sales to Italy, Hungary and Greece plunged by between 60% and 90% over the year, reducing the EU's share to 36.8% of Montenegro's total trade in 2012, from 41.3% the year before. The CEFTA countries increased their share to 47.5% of Montenegro's total trade in 2012, from 44% a year earlier. In the six months to June 2013, the share of trade with the EU and CEFTA decreased marginally to 36.4% and 47.1% respectively. In 2012, the EU accounted for 50% of total investment in Montenegro. Russia is still the single largest investor in Montenegro, with 25% of total FDI, of which 82% is in real estate. CEFTA countries accounted for 5% of total net FDI. The reduction of production costs through wage moderation preserved Montenegro's external competitiveness to some extent. *Overall*, trade integration with the EU remains high.

3.3. CONCLUSIONS

As regards the economic criteria, Montenegro has made some further progress towards a functioning market economy. The country 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 weaknesses through appropriate macroeconomic policies and structural reforms.

After entering in recession in 2012, the country came out of recession in 2013. The resilience of tourism and foreign direct investments (FDI) together with an increase of electricity exports supported the recovery, compensating for a weak domestic demand. The current account deficit is declining, but still remains very high. In July, the aluminium producer KAP was put into bankruptcy procedure, which represents a risk to public finances, in view of the considerable size of contingent liabilities. Unemployment remained very high. Credit growth turned positive after four years of contraction, but the high levels of non-performing loans still weigh on bank capitalisation and hence, on credit supply.

To cope with the existing economic challenges and to reduce external imbalances, Montenegro needs to strengthen competitiveness, by improving productivity and attracting further FDI into more sectors than tourism and real estate. The establishment of a sound business environment continues to be hampered by the weak rule of law and corruption. The high unemployment rate requires bridging the gap between supply and demand of labour skills and allowing more independent wage setting at company level. It also requires the strengthening of the public employment service in order to implement the activation policies and establish an inclusive and efficient labour market. Authorities should consider objectively the viability of the aluminium conglomerate under market conditions and the best possible solution without exacerbating the pressure on public finances. The path of fiscal consolidation should be continued, including efforts to collect tax arrears. The high level of non-performing loans remains a matter of concern and calls for a reinforced banking supervision enforcing adequate provisioning. The informal sector remains an important challenge.

4. SERBIA

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

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In January 2013, the government submitted to the European Commission its Pre-Accession Economic Programme (PEP) for the period 2013-2015. The programme foresees a mild and plausible recovery by 2% in 2013 and further, rather optimistic, acceleration of real GDP growth to 3.5% and 4% in the following two years. A fiscal consolidation package, mostly on the revenue side, was adopted in the autumn of 2012. Revenue underperformance and expenditure pressures led to another set of consolidation measures in July and to a rebalancing of the budget, increasing the 2013 deficit target from the initial 3.6% of GDP to an estimated 5.3% of GDP. Some steps to address the numerous obstacles to growth have been taken, but the adoption and implementation of a number of important structural reforms has been delayed. The pre-cautionary Stand-By Arrangement (SBA) with the IMF expired in March 2013, without being activated and no new arrangement has been concluded. *Overall*, in view of the difficult economic situation, economic reforms have progressed slowly. Achieving a sustainable fiscal position and tackling the numerous obstacles to growth remains a challenge.

Macroeconomic stability

In 2012, Serbia went through another recession and the economy contracted by 1.7%. Domestic demand weakened significantly in the last quarter when private consumption fell by 2% and gross fixed capital formation by 3.4%. Loose fiscal policy, which had boosted government expenditure and led to a strong public consumption growth in the pre-election period, was reversed by the year's end and exports remained the only driver of growth. Real GDP grew by 2.1% in the first and by 0.7% in the second quarter. However, economic growth has been uneven, concentrated in few sectors, and employment stagnated. Private consumption has continued to decrease and import growth lost pace. Activity in key sectors such as construction and retail trade continued to decline. Average per capita income in purchasing power standards stood at 35% of the EU average in 2012, unchanged from the year before. *Overall*, the economy is slowly emerging from another recession but growth remains weak and narrowly based.

The economy is still facing significant external imbalances. In 2012, the current account deficit increased to 10.5% of GDP, driven mainly by an expanding trade deficit. However, this trend was reversed by the end of the year and, in the first half of 2013 the annualised current account deficit shrank by half in euro terms to an estimated 5.7% of GDP. By July, exports of goods and services were up by 20% in euro terms, explaining the bulk of the current account adjustment while, due to falling domestic demand, imports remained subdued. Despite a slowdown in the EU economies hosting significant Serbian diaspora, private remittances increased strongly by 13% in the first seven months.

External financial flows have been volatile and government borrowing replaced private sector inflows as the main source of financing of the current account deficit. Due to significant outflows, net foreign direct investment fell to 0.8% of GDP in 2012. It gained some ground in 2013, but remained far below pre-crisis levels, as domestic risks and weak EU economy supressed inflows. Wholesale trade, construction and financial services sectors attracted more than half of all net foreign investment in the country, while inflows into sectors that could potentially boost export capacity remained marginal.

Portfolio investment increased as a result of significant government borrowing (three rounds of eurobonds denominated in US dollars, totalling about €2.5 billion). In the first half of 2013, banks continued to reduce their foreign liabilities. The central bank foreign exchange reserves stood at a comfortable €10.7 billion in August, covering more than seven months' worth of imports. Private sector external debt has remained fairly stable; however, since September, rising government indebtedness has kept total external debt high, at 83.7% of GDP by the end of June. *Overall*, external imbalances have been falling but remain significant. Government borrowing replaced private sector inflows as the main source of financing of the current account deficit.

Table 4.1:
Serbia - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	3,8	-3,5	1,0	1,6	-1,7	1,5
Private consumption	Ann. % ch	6,8	-2,7	-1,0	-1,2	-2,0	-1,5
Gross fixed capital formation	Ann. % ch	8,5	-22,1	-5,5	8,4	-3,4	10,7
Unemployment (>15 years old)	%	13,6	16,1	19,2	23,0	23,9	24.1*
Employment (registered)	Ann. % ch	-0,1	-6,1	-3,6	-3,1	-1,1	-0,6
Wages (average, net real)	Ann. % ch	4,5	1,0	7,4	11,1	9,2	6,0
Current account balance	% of GDP	-18,8	-7,2	-7,6	-9,2	-10,6	-7,7
Direct investment (FDI, net)	% of GDP	5,7	4,7	3,1	5,9	0,8	2,3
CPI (end of period)	Ann. % ch	8,6	6,6	10,3	7,0	12,2	9,8
Interest rate (3 months)	% p.a.	5,20	13,40	10,85	12,56	12,50	9,69
Stock markets	Index	2.604	1.197	1.283	1.270	932	1.042
Exchange rate RSD/EUR	Value	81,94	94,08	103,48	102,01	113,52	111,81
Nominal eff. exchange rate	Index	96,9	89,6	79,3	81,8	74,1	74,5
General government balance	% of GDP	-2,6	-4,5	-4,7	-4,9	-6,4	-5,1
General government debt	% of GDP	29,2	34,7	44,5	48,2	59,3	60,7

* Q1
Sources: Thomson Reuters/Ecowin, Eurostat

In 2012, the unemployment rate increased to a record high of 23.9%. According to the April Labour Force Survey, the employment rate reached an eleven-year low, while the activity rate edged slightly up but was still very low at 47.9%. Only about one person in three above the age of 15 was employed. Employment in the unreformed public sector remained largely intact. Long-term and youth unemployment have been persistently high and unemployment is very high almost everywhere throughout the country. There are a number of restrictions related to severance payments, duration of fixed-term employment, industry-wide collective agreements, termination of employment, payroll calculation and compensations which are obstacles to job creation and reduce labour flexibility. The first signs of economic recovery in 2013 did not spill over to the labour market. The number of registered employed continued to fall and registered unemployment crept up. Since September last year, gross and net wages have been declining in real terms. In the first seven months of 2013, real wages fell by 4.3% on average. Departing from regular indexation rules, due to the difficult economic situation, the government increased wages in the public sector by 2% in October and April although, at 11% of GDP in 2012, total government spending on wages and salaries remains relatively high. *Overall*, unemployment is very high and sustainable employment creation represents a major challenge. Labour market rigidities are significant.

The monetary policy framework remained unchanged and the National Bank of Serbia reconfirmed its commitment to inflation targeting. In November, parliament passed amendments to the Law on the National Bank, which aimed at correcting some of the amendments of August 2012, which had undermined the independence of the central bank. Until April, annual inflation remained at double-digit levels, spurred by a legacy from 2012 of depreciating currency, hikes in indirect taxes and high food prices, and the inflation target (4% ±1.5 percentage points) was missed by a wide margin. However, since November monthly inflation rates have come down, averaging 0.2% in the period until August, due to weak domestic demand, mostly stable exchange rate and delayed adjustments in

administered prices. These factors, along with base effects and food price moderation because of better agricultural season, supported rapid disinflation over the summer and inflation fell to 7.3% in August.

The central bank responded to the elevated inflation by tightening its stance, raising the key interest rate in every month from September (10.5%) to February (11.75%). As inflationary pressures started dissipating, in May the bank lowered its key rate by half a percentage point, to 11.25%, followed by another cut to 11.00% in June. Reduced political risks, improving external accounts and tighter monetary policy have broadly stabilised the exchange rate. From September to April, the dinar appreciated vis-à-vis the euro by around 4% and, although this trend was reversed in early June, by early September 2013 the dinar was still stronger than a year ago. The central bank continued interventions to smoothen excessive daily volatility on the foreign exchange market. In view of the high degree of euroisation of the economy and significant pass-through effects on inflation, the relatively stable exchange rate played a significant role in stabilising inflation. *Overall*, inflationary pressures have receded, helped by a stronger dinar, subdued domestic demand and a better agricultural season. However, inflation remains inherently volatile, heavily dependent on unstable food prices and exchange rate fluctuations.

In 2012, an election year, budget expenditures went off-track across almost all major categories, reaching their highest level in years. Most importantly, previous small gains in expenditure consolidation, in particular in compensation of employees, subsidies and pensions, have been wiped out. In a revised budget, adopted in September 2012, the new government took a number of consolidation measures, mostly on the revenue side. Nevertheless, the deficit overshot by far the initial target of 4.25% and reached 6.4% of GDP and was even higher if expenditure on bank recapitalisations and called guarantees are taken into account.

Building on the measures adopted in the autumn, the 2013 budget envisaged a sharp deficit reduction to 3.6% of GDP. However, tax revenue underperformed from the beginning of the year, putting this target beyond reach. By the end of April, the general government deficit stood at 46% of the planned for the year. The higher than expected deficit prompted another round of measures in May and led to a full budget revision, adopted by the parliament in July. The May measures were mainly on the revenue side and included a reduction of the wage tax and increases of employees' social security contribution and of the property tax base. The July revision raised the annual deficit target from 3.6% to an estimated 5.3% of GDP. It envisaged cuts in ministries' expenditure allocations, fixed indexation of wages and salaries by 0.5% in October 2013 and increases in some outlays. The government also adopted a public sector reform programme, including an action plan to finalise enterprise restructuring by mid-2014. By the end of August, total revenue declined by 4.1%, while public expenditure have been kept largely in check and declined by 5.8% in real terms. However, quasi-fiscal expenditure, related to bank recapitalisations and payments on called guarantees, have been significant, undermining budget transparency and weighing heavily on public finances. *Overall*, a series of measures, mostly on the revenue side, failed to deliver the expected reduction of the deficit. Expenditure inefficiencies and the high level of spending on wages and pensions still need to be addressed in a systematic way.

Fiscal rules were breached and government debt significantly exceeded the 45% of GDP limit, reaching close to 60% in 2012. In line with legislative requirements, the government presented a programme of reducing government debt, according to which, and in a rather optimistic scenario, it will take until 2020 until the debt falls again below the 45% threshold. In 2013, the high budget deficit and new government borrowing continued to push the debt up. Since the beginning of the year, government-guaranteed debt and called guarantees have also increased, reflecting continued government support of loss-making public enterprises. Taking advantage of the favourable international environment and declining interest rates on the domestic government bonds market, in April the government prepaid some €330 million of its obligations towards the London Club. Interest

payments to service the debt went up by 55% to 2.0% of GDP in 2012 and increased further in 2013. *Overall*, the adoption and implementation of a credible medium-term fiscal adjustment programme, backed by systemic reforms of the public sector to restore fiscal sustainability and stem further rise in the government debt, is urgently needed.

Recent fiscal consolidation efforts have been mainly on the revenue side where the space for further measures has been largely exhausted, with the exception of decreasing costly tax expenditures and improving collection. Some small steps have been taken to reduce and restructure current expenditure and to tackle spending inefficiencies but the big and unreformed public sector remains a significant drain on the budget. High export growth has softened the effects of depressed domestic demand and reduced external imbalances, relieving some of the depreciating pressures on the dinar. Inflation decelerated but monetary policy continues to be restricted by unstable food prices, irregular administered price adjustments and the high degree of euroisation of the economy. *Overall*, achieving a proper policy mix is still a challenge. Revenue-based fiscal adjustment has largely reached its limits and monetary policy efficiency remains constrained.

Interplay of market forces

Due to changes in consumer prices' basket, the proportion of administered prices fell by 2 percentage points to 20%. Since the beginning of the year, gas prices were adjusted twice, while a planned electricity price increase was postponed several times until August, when the price was raised on average by 11.3% (10.9% for households). As of 2013, the electricity and gas markets have been liberalised for big consumers connected to the transmission network which need to buy energy at strictly market prices. The government continued to control prices of some public utilities indirectly by setting a limit on increases in the prices of communal and public city transport services which are under the control of the local authorities. In November, the government adopted new criteria for wholesale and retail price formation for medicines for human consumption issued on prescription. The government decree which capped retail margins at 10% for basic foodstuffs expired at the end of 2012. *Overall*, price liberalisation has advanced but state control over prices remains significant.

The state holds predominant stakes in major sectors such as energy, transport and telecommunications. Some legislative efforts were made to improve the operation of public companies, which continued to be poorly managed, largely overstaffed and loss making. A law on public companies was adopted, setting criteria and delineating a procedure for the appointment of companies' management. The government continued to provide state guarantees for liquidity loans to major companies and 'ad hoc' subsidies to selected manufacturing state-owned enterprises to cover capital investment in modernising their equipment. Some of the large state-owned companies have been tendered (unsuccessfully) for privatisation or are in the process of setting up strategic partnerships with foreign investors. In April, with significant support from the state, the government partially re-started production in the loss-making steel mill in Smederevo.

In order to revive the privatisation of socially owned enterprises, the Law on Privatisation was amended in December 2012, enabling creditors' forced collection of their claims against entities subject to privatisation after 30 June 2014. An action plan to restructure 179 of these companies was adopted in June, with a view to privatising the viable ones (fully or partially) and selling off assets and initiating bankruptcy procedures for those enterprises that have no market prospects. In line with the plan, a bankruptcy procedure for 26 enterprises has already been initiated. *Overall*, some steps have been taken to revive the privatisation process, especially regarding enterprises undergoing restructuring. The state presence in the economy remains significant and state-owned companies continued to accumulate losses.

Market entry and exit

The introduction of the 'one-stop shop' business registration system in 2009 has significantly improved the efficiency and speed of the registration procedure. As of October 2012, the fee for obtaining a company registration code, assigned by the Statistical Office, was abolished. However, market entry is still hampered by lengthy and costly procedures for granting various permits, notably construction permits. With amendments to the Law on Planning and Construction, adopted in late December, the requirement for converting use rights into ownership rights in order to receive a construction permit, for land obtained through privatisation, was abolished for one year. In May, the Constitutional Court suspended the execution of this provision until determining its constitutionality. In the first half of 2013, the number of companies with blocked accounts reached 44.7 thousand, marking a drop of around 25% since September. *Overall*, red tape and difficulties in obtaining construction permits continue to be important obstacles for business expansion.

Legal system

While the legal basis has developed further, the implementation of laws needs to be seriously strengthened. The uneven and slow enforcement of laws has an impact on the cost of doing business. The backlog in the courts is still substantial and companies — aware of the limitations of the system — often avoid using the courts as a legal solution to their problems. Enforcement of restitution legislation, which is expected to improve legal clarity over real estate ownership, is ongoing. By August 2013, about 25% of all submitted claims were resolved. A new Law on Public Procurement, increasing transparency and including measures to prevent corruption and conflicts of interest, was adopted in December. The informal economy remains strong and is a major hindrance to fair competition and business development. Corruption harms the business environment, although the fight against it has intensified. *Overall*, legal predictability and enforcement of court decisions remain weak. Some progress has been made in improving property rights. Further concrete steps should be taken swiftly to improve the business environment.

Financial sector development

Part of the banking system has been under stress, which has prompted state intervention, costly recapitalisations and consolidation of state-owned banks. In October, parliament passed a law allowing assets and liabilities from problematic state-owned banks to be transferred to viable banks. On this basis, the cases of two troubled banks (Agrobanka and Development Bank of Vojvodina) have been resolved with unlimited coverage of deposits. Further steps in bank consolidation were made when Telenor Serbia, a major telecom operator in the country, took over the local KBC Banka, while Société Générale Bank assumed KBC's clients and portfolio. A total of 31 banks were operating in mid-2013 — two less than a year earlier. The banking sector continued to dominate the financial system, accounting for 93% of total assets in 2012. Within the banking sector, foreign-owned banks are preponderant. As of June, there were 21 foreign banks, accounting for three quarters of the assets, almost 80% of lending and 70% of all bank deposits. There were also seven banks controlled by the state and only three small private banks. Financial intermediation remained broadly unchanged and banking sector assets amounted to 91.8% of GDP by the end of 2012.

Capital adequacy indicators improved and the regulatory capital to risk-weighted assets of the system stood at 20.2% in June, well above the required minimum of 12%. The level of Euroisation remained high, with about 81% of deposits and 72% of households and enterprises loans denominated in or linked to foreign currency. Lending activity decelerated significantly and, excluding the exchange rate effect, domestic lending growth fell to 1% in June. Corporate loans declined the most, especially after subsidised lending was suspended due to exhaustion of funds, while household lending increased only marginally. Commercial banks opted for low-risk investments, increasing their holdings at the central bank and reducing external liabilities. A weak labour market and falling incomes have undermined the

growth of non-monetary sector deposits, which has steadily decelerated. The quality of the loan portfolio worsened, mainly in its corporate sector segment, and the gross non-performing loans ratio reached 19.9% in June. In December, the central bank amended its Decisions on Risk Management and on the Classification of Bank Balance Sheet Assets and Off-balance Sheet Items with the aim of facilitating the resolution of accumulated non-performing loans. Following the closure of Agrobanka, which had made significant losses, bank profitability improved. Still, a number of small banks, holding a combined market share of around 15%, continued to run losses. *Overall*, banking sector capitalisation and liquidity indicators remained strong. However, credit growth stagnated, non-performing loans are high and vulnerabilities need to be addressed.

The main index of the Belgrade Stock Exchange BelexLine has increased by 28% (from September) by early April, before losing more than half of this gain during the summer. The insurance sector remains underdeveloped, with a ratio of total premiums to GDP at 1.8% and per capita premiums of about €75. The sector is dominated by non-life insurance, which accounted for 80.7% of total premiums. The number of insurance companies remained unchanged at 28, of which 24 were engaged exclusively in insurance business and 4 in reinsurance. Most of the companies (21) were under majority foreign ownership and they dominated the market with a share of 90.8% in life premiums, 57.6% in non-life premiums, 68.8% in total assets and 65.5% in employment. The insurance sector's share of total financial sector assets increased slightly, to 4.5% in 2012. The assets controlled by voluntary pension funds have increased but are still marginal at 0.5% of GDP, while the importance and operations of leasing companies continued to decline. *Overall*, the non-banking financial sector remains underdeveloped.

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

Existence of a functioning market economy

State presence in the economy remains significant, while the private sector is weak and unprotected as the rule of law is not systematically observed. Economic reforms have progressed slowly. Domestic and external deficits remain high and there are significant structural rigidities and obstacles to growth. *Overall*, the functioning of market mechanisms remains hampered by distortions and legal uncertainty.

Human and physical capital

The gap between supply and demand of skilled workforce remains and the education system continues to educate a workforce that does not necessarily correspond to the needs of the economy. As a consequence, the main features of the labour market are high unemployment of people with lower and intermediate education, and high long-term and youth unemployment. In October 2012, the government adopted an education strategy, which envisages a number of measures to improve the quality of education at all levels by 2020. However, action plans for implementing the strategy have so far not been drafted and funding is constrained by the need to pursue expenditure-based fiscal consolidation. Active labour market programmes remain underfunded and do not seriously address youth and long-term unemployment. *Overall*, the education strategy is ambitious but its implementation is a challenge.

Serbia continues to need significant investment to improve and upgrade its physical infrastructure, which has been neglected for many years. Government investment increased to 3.7% of GDP in 2012 but remains low and declined by 37% in real terms in the first eight months of 2013. Works on major transport corridors are progressing slowly, delayed in part by land expropriation issues, overlapping competencies of different institutions and lack of project documentation. Energy efficiency continues

to be low and energy infrastructure, in particular electricity generation and distribution, needs further investment. Steps have been taken to secure foreign financing for big infrastructure projects in the transport and energy sectors, which may help to speed up work on strategically important projects. Greenfield foreign direct investment (FDI) has been marginal, despite continued provision of costly government subsidies. *Overall*, the physical infrastructure needs substantial investment. Government investment is constrained by the tight financial conditions and the urgent need of further fiscal consolidation. Securing financing for large transport and energy projects need to be in line with public debt sustainability.

Sectoral and enterprise structure

Following particularly bad weather in the winter and a drought in the summer, in 2012 the value added in agriculture declined by 17% and its share of gross value added dropped to 10.4% from 10.8% a year earlier. Industry's share also fell, from 29.3% to 28.7%, while services increased their share to 61% of GDP. Employment remained roughly unchanged across the sectors. The informal sector, driven by labour law rigidities and taking advantage of weaknesses in tax and expenditure policies and in law enforcement, remained significant. *Overall*, the economy is dominated by services, although agriculture's share remains high. The informal sector is a significant challenge.

State influence on competitiveness

State aid reported in 2012 was 7% higher than in 2011, representing 2.6% of GDP. Of the total state aid granted in 2012, 35.8% was regional aid, 13.6% was in the form of other horizontal aid, 22% was sectoral aid, and 28.6% went to agriculture. There was very little aid given to training and to research and development. Most of the aid was given in subsidies (close to 60%) or as tax incentives (32.6% of total). State-controlled, monopolistic structures remain in a large number of sectors and the state continued to subsidise heavily the transport sector, which received almost a fifth of all aid. State aid control needs to be enforced consistently and the exemption from state aid rules given to enterprises that are being privatised still needs to be abolished. New state aid measures need to be systematically notified before being put into force. The Commission for State Aid Control still has to demonstrate its independence through ex post controls and use of the provision on recovery of unlawful state aid. *Overall*, the state continues to substantially influence competitiveness by providing significant and wide-ranging forms of state aid.

Economic integration with the EU

The EU remains Serbia's main trading partner, accounting for 58.1% of its total exports and 58.2% of its imports in 2012. Shares of both Serbia's exports to the EU and imports from the EU have increased slightly in comparison to 2011. Serbia's exports to the EU have grown faster than its imports, resulting in an increase in the export to import ratio vis-à-vis the EU from 48% in 2009 to 60% in 2012. The CEFTA countries accounted for 32.4% of total exports and 10.4% of total imports in 2012. The share of net FDI inflows from the EU in total net FDI inflows stood at 64% in 2012. The average real gross wage growth was 1% in 2012, while average labour productivity growth was negative, translating into an increase in real unit labour costs. In real effective terms (deflated by inflation), the dinar depreciated on average by 7.7% in 2012. However, the depreciating trend was turned around in August 2012 and by August 2013 the dinar strengthened by 10.4%. *Overall*, trade integration with the EU remained high.

4.3. CONCLUSIONS

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

In 2012, Serbia went through another recession and the economy contracted by 1.7%. High exports growth has softened the effects of depressed domestic demand and led to a mild and uneven recovery in the first half of 2013. A series of fiscal consolidation efforts were taken mostly on the revenue side. The process of restructuring state-owned enterprises was revived. Some progress has been made with regards to fighting corruption and improving property rights.

Growth remains narrowly based and the first signs of economic recovery in 2013 did not spill over to the labour market. Unemployment and the budget deficit remain very high. Rigidities persisted on the labour market and sustainable employment creation represents a major challenge. The adoption of a credible medium-term fiscal adjustment programme is still lacking. State presence in the economy is significant and state-owned companies continued to accumulate big losses. Serbia needs to continue improving the business environment and should make strong efforts to develop a competitive private sector. The functioning of market mechanisms is hampered by legal uncertainty and corruption. The informal sector remains an important challenge.

5. TURKEY

In examining economic developments in Turkey, the Commission's approach was guided by the conclusions of the Copenhagen European Council 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

The Pre-Accession Economic Programme (PEP) for 2013-15, submitted to the Commission in January 2013, is based on the assumption of relatively moderate growth and a further reduction of the current account deficit. However, even in this relatively optimistic scenario, the external deficit remains large. Combined with a precarious external debt structure, it makes Turkey vulnerable to capital flow reversals, either in the context of increasing global risk aversion regarding emerging market assets, or as a result of a rise in perceived country-specific risks. The fragmentation of responsibilities between government bodies continues to complicate the coordination of budgeting and medium-term economic policy-making. However, it seems that economic policies have not been affected by internal conflicts and tensions in recent times. *Overall*, the consensus on economic policy essentials has apparently been preserved.

Macroeconomic stability

In 2012, the Turkish economy continued a slowdown which had started in the middle of the previous year. Year-on-year growth rates declined gradually from 5.3% in the fourth quarter of 2011 to 1.4% in the fourth quarter of 2012. In seasonally adjusted quarter-on-quarter terms, real GDP barely grew in the second half of 2012. Annual GDP growth dropped from 8.8% in 2011 to 2.2% in 2012. The slowdown was combined with a rebalancing of growth from domestic demand to export-led growth. Private consumption and investment declined by 0.6% and 4.8%, respectively. Export volumes, on the other hand, accelerated to an annual growth rate of 16.7%. Most of this impressive rise was, however, accounted for by extraordinary exports of non-monetary gold to Iran. Import volumes stagnated as a consequence of the retrenchment in domestic demand. The only domestic demand component which added to GDP growth in 2012 was public spending. Public consumption and investment expanded by 6.1% and 9.3%, respectively.

In the first half of 2013, overall domestic demand started to recover, not least due to strongly increasing public spending, particularly investment. Private investment, however, continued to contract. Consumer spending returned to a moderate growth path helped by some decline in interest rates. Export growth fell back to 3.2% year-on-year as gold exports declined sharply from the previous year's levels. Import growth of 9.5% reflects to a large extent surging gold imports. The net result from the contributions of the various components was 3.7% year-on-year GDP growth in the first half. In seasonally adjusted quarter-on-quarter terms, GDP growth increased from 0.2% growth in the fourth quarter of 2012 to 1.5% in the first quarter and to 2.1% in the second quarter of 2013. In 2012, the per capita GDP of Turkey (PPP adjusted) amounted to 56% of the EU average, up from 52% in 2011. *Overall*, the economic slowdown has ceased and economic activity has re-accelerated in the first half of 2013.

Table 5.1:
Turkey - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	0,7	-4,8	9,2	8,8	2,2	3,7
Private consumption	Ann. % ch	-0,3	-2,3	6,7	7,7	-0,6	4,2
Gross fixed capital formation	Ann. % ch	-6,2	-19,0	30,5	18,0	-2,7	3,0
Unemployment	%	11,0	14,1	12,0	9,8	9,2	9,7
Employment	Ann. % ch	1,3	0,4	6,2	6,7	3,0	4,3
Wages	Ann. % ch	11,5	9,9	11,8	9,7	11,5	11,2
Current account balance	% of GDP	-5,4	-2,0	-6,2	-9,7	-6,0	-6,3
Direct investment (FDI, net)	% of GDP	2,3	1,2	1,0	1,8	1,1	0,9
CPI	Ann. % ch	10,4	6,3	8,6	6,5	8,9	7,1
Interest rate (3 months)	% p.a.	18,04	10,68	7,95	9,09	10,31	11,76
Stock markets	Index	37.582	37.510	59.484	60.751	63.731	82.351
Exchange rate TRY/EUR	Value	1,91	2,16	2,00	2,33	2,31	2,38
Nominal eff. exchange rate	Index	91,7	82,8	86,2	74,1	72,4	N.A.
General government balance	% of GDP	-2,2	-7,0	-2,6	-2,2	-2,3	0,6
General government debt	% of GDP	39,5	45,5	42,4	39,8	37,9	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

The current account has continued to register a large deficit, which leaves the Turkish currency vulnerable to sudden loss of investor confidence. In conjunction with the softening of domestic demand and strong export growth, the current account narrowed significantly from 9.7% of GDP in 2011 to 6.0% in 2012. Most importantly, imports of goods declined by 1.5%, while exports of goods surged by 13.9% in value terms. The balance of payments data for the first half of 2013 suggest a reversal of this trend, as goods exports increased much more moderately (2.8% year-on-year) while goods imports recovered strongly (7.1%). The 12-month cumulative current account deficit has risen back up to 6.6% of GDP. However, Turkey’s foreign trade data have been distorted by strong fluctuations in exports and imports of non-monetary gold in recent years. Net exports of gold in 2012, corresponding to 0.7% of GDP, were succeeded by large net imports in the first six months of 2013.

The bulk of the current account deficit was financed by portfolio investments in 2012, while net inflows of foreign direct investments covered a relatively small proportion (17.8%) of the deficit. The high degree of dependence on shorter-term capital inflows exposes Turkey to changes in global risk appetite. The central bank’s foreign exchange reserves increased from €56 billion at the end of 2011 to €78 billion at the end of 2012 and further to €94 billion at the end of June 2013 (16% of GDP). The gross foreign debt rose by 10.8% in the course of 2012, but expressed as a proportion of GDP it fell by 1.8 percentage points to 42.5%. *Overall*, the external imbalances have remained significant and their short-term financing makes the country vulnerable to sudden changes in global investor sentiment.

The labour market performed relatively well in 2012 despite the economic slowdown. For the population aged 20-64, the annual unemployment rate fell from 8.8% in 2011 to 8.2% as employment rose by 3.0%. The employment rate increased by 0.6 percentage points to 52.8% while the labour force participation rate increased by 0.2 percentage points to 57.4%. When economic growth picked up in the first six months of 2013, average employment accelerated to a growth rate of 4.1% year-on-year. Nevertheless, the average unemployment rate was 0.4 percentage points higher year-on-year in this period because the labour force rose even faster than employment.

While the employment rate was 75.0% for men in 2012, it was as low as 30.9% for women. Despite the low proportion of the female population actively looking for work, the female unemployment rate is 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. The efficient functioning of the labour market continues to be impeded by a lack of flexibility, regarding labour contracts for instance,

and undeclared work remains a widespread practice. *Overall*, employment has continued to grow at a robust rate and unemployment edged down in 2012, but the female employment rate has remained very low.

In the context of a generally strengthening currency and the slowing down of the economy, consumer price inflation decreased from 10.5% at the end of 2011 to 6.2% at the end of 2012. This outcome was above the central bank's year-end target of 5% but within its tolerance band of +/- 2% around the target. While core goods inflation was trending downward in 2012, services inflation was relatively stable. In the first eight months of 2013, increases in unprocessed food prices, tax adjustments for tobacco products, and the lira depreciation over the summer months have pushed up inflation. *Overall*, inflation was reduced noticeably in 2012, but has picked up again more recently and remains above the central bank's target.

The central bank has continued to apply and refine the unconventional monetary policy framework, adopted in late 2010, in which inflation and macro-financial stability are the main targets. In the conduct of monetary policy, the bank is attaching a reference value of 15% to credit growth, defined as the year-on-year change in bank credit to the non-financial sector. It also targets the floating exchange rate of the Turkish lira by aiming to dampen short-term volatility and by responding to exchange rate movements which are considered to constitute excessive appreciations or depreciations of the lira. As regards the instruments of monetary policy, a wide variety of tools is applied in a complex interplay, including reserve requirement ratios and a mix of various repo facilities. Following a period with a relatively tight monetary stance to cool down an overheating domestic economy, the central bank adopted a more accommodative stance in the second half of 2012, when economic activity had stabilised and the Turkish lira had appreciated noticeably. The interest rate corridor between the central bank's overnight borrowing and lending rates has been moved gradually downward and narrowed from 5-11.5% to 3.5-6.5% between September 2012 and May 2013. Within the same period, the central bank's policy rate (the one-week repo rate) was cut in three steps from 5.75% to 4.5% with a view to supporting the domestic economy and containing further currency appreciation. The Turkish lira appreciated by 7.8% in the course of 2012 in real effective terms and by a further 1.5% over the first five months of 2013. Since May, Turkey's financial markets and the Turkish lira have come under severe downward pressure in the context of anticipated changes in international monetary conditions, domestic political unrest and the civil war in neighbouring Syria. Net capital inflows in the first five months of the year have been succeeded by significant net capital outflows. In response, the central bank has intervened directly in the foreign exchange market by selling foreign exchange reserves equal to €6.7 billion in June-August. It has also raised the upper band of the interest rate corridor (the lending rate) by a combined 125 basis points to 7.75%. *Overall*, the central bank continued to pursue multiple objectives within an unconventional and complex monetary policy framework that hampers transparency and predictability. The policy stance was adjusted frequently in response to changing domestic and international conditions.

In contrast to the preceding years, the fiscal target was missed in 2012 due to expenditure overruns and an economic slowdown which was faster than the authorities expected. The central government's budget deficit widened from 1.4% of GDP in 2011 to 2.0% (the original target was 1.5%). The lack of timely information on the fiscal balance of general government continues to reduce the transparency of overall public finances. Central government revenues from indirect taxes fell short of budget, as private consumption contracted while central government expenditures, particularly for the compensation of public employees, rose faster than planned. The expenditure overruns were also caused by government transfers to state-owned enterprises as a result of delayed price adjustments in the energy sector. In the first six months of 2013, the fiscal performance improved, with the central government's 12-month rolling budget deficit falling to 1.3% of GDP in June, as compared with an unambitious 2013 deficit target of 2.2%. A surge in revenues reflects the recovery in economic activity and the indirect tax hikes from last September. Non-interest expenditures have also increased strongly, not least for public investment, in spite of a projected decline in capital spending as a

proportion of GDP in 2013 in Turkey's 2013-15 Pre-Accession Economic Programme. Part of the rise in non-interest expenditures has been offset by a decline in interest expenses. Although general government debt (for which data are available) increased marginally in absolute terms in 2012, the debt-to-GDP ratio fell from 39.1% at the end of 2011 to 36.2% at the end of 2012 due to high nominal GDP growth. Over the same period, the average maturity of the outstanding debt stock was extended from 55 to 69 months while the average borrowing rate was reduced from 9.8% to 6.4%. *Overall*, the fiscal performance suffered from continuing expenditure overruns, but was satisfactory regarding the sustainability of public debt. There was no progress on increasing the transparency of the fiscal framework and adopting a fiscal rule.

The tightening of monetary policy from the summer of 2011 onwards contributed to lowering output growth to a more sustainable level and to reducing inflation and the large current account deficit in 2012. The reorientation of monetary policy towards easing between mid-2012 and May 2013 seems to have been similarly helpful in stimulating a re-acceleration of economic activity in the first half of 2013. It remains to be seen how the renewed monetary tightening in the summer of 2013 will affect the real economy. Fiscal policy has been less responsive to macroeconomic needs in the recent past as public expenditures have become more rigid. This has reduced the ability of fiscal policy to contribute to a more balanced macroeconomic policy mix, thereby putting an excessive burden on monetary policy to deliver on multiple targets. The adoption of a strong fiscal rule would not only enhance budgetary transparency but also provide a fiscal anchor and enhance credibility. Fiscal policy also has an important role to play in increasing domestic saving and thereby reducing Turkey's reliance on external financing. The dependence on capital inflows is a macroeconomic vulnerability which makes Turkey prone to boom-bust cycles. *Overall*, the Turkish economy remains vulnerable to bouts of financial uncertainty and changes in global risk sentiment and there is scope for improving the macroeconomic policy mix.

Interplay of market forces

The share of directly administered prices in the Consumer Price Index (CPI) basket has remained at the relatively low level of 4.5%. However, food and alcohol prices, which together make up more than 25% of the consumer basket, are highly sensitive to policy and administrative decisions. For transport and energy (natural gas and electricity), automatic pricing mechanisms are applied in principle, linking end-user prices to a cost-based methodology. In practice, however, the government continues to set end-user prices, thereby effectively suspending the automatic pricing mechanisms. There has been some reduction in cross-subsidisation between consumers in the wholesale and retail electricity markets.

There has been limited progress in the restructuring and transparency of state-owned enterprises related to the privatisation of energy generation and distribution assets. The private sector's share in GDP decreased somewhat as private investment contracted while public investments continued to expand. As investors' access to long-term external financing improved in 2012, the pace of privatisations increased, but remained below initial targets. The total volume of completed deals more than doubled, to €2.34 billion (0.4% of GDP), as compared with 2011, but was still less than half the average 2005-08 level. The secondary public offering of the state-owned Halkbank represented 65% of the privatisation revenue. The tender for the privatisation of highways and bridges was cancelled as the government refused offers. Privatisation tenders continued in early 2013, particularly in the energy sector. *Overall*, there has been no progress in price liberalisation as the government continues to interfere in the price-setting mechanism in key sectors. Privatisation has re-accelerated, but remains at a relatively low level.

Market entry and exit

In 2012, the number of newly-established businesses fell by 6.7% as compared with the previous year. Starting a business in Turkey requires six separate procedures, takes six days, and costs 10.5% of per capita income on average. Some fees are still not transparent, such as those for the official registration of a company's articles and accounts. Trade registry fees remain significant. Obtaining a construction permit is still very cumbersome and time-consuming. The number of businesses closing down or being liquidated fell by 13.9% as compared with 2011. Closing a business remains expensive and time-consuming. Insolvency procedures take about 3.3 years and recovery rates — at 23.6% on average — remain very low. *Overall*, market entry conditions are satisfactory, while market exit remains costly and long, and insolvency proceedings are still heavy and inefficient.

Legal system

A reasonably well-functioning legal system, including in the area of property rights, has been in place for several years. Enforcement of commercial contracts is still a rather lengthy process, partly because commercial court judges are insufficiently specialised. Out-of-court dispute settlement mechanisms are seldom used, major exceptions being the insurance sector, tax and customs. The judicial system and administrative capacity could be further improved. *Overall*, the legal system continues to function relatively well, but no progress has been observed.

Financial sector development

Banks have continued to dominate the financial sector with their share of the sector's total assets remaining at 88%, while the share of the relatively small insurance sector (including private pensions) increased from 4.0% in 2011 to 4.6% in 2012. The value of banking sector assets increased from 94% of GDP in 2011 to 97% in 2012. The share of state-owned banks in total banking sector assets decreased from 25.5% in 2011 to 23.1% in 2012. After the partial privatisation of Halkbank, the state's share in the bank decreased from 75% to 51.1%. The share of foreign-owned banks (where international banks either have a controlling share or have an equal partnership with a local partner) decreased slightly from 41.6% in 2011 to 41.3% in 2012.

In tune with the monetary policy stance, credit expansion continued to slow down in the first three quarters of 2012. Following the switch to a more accommodative monetary policy, the foreign-exchange adjusted loan portfolio of banks started to accelerate again in November 2012 and reached a growth rate of 23.1% year-on-year at the end of June 2013. The banks' loan-to-deposit ratio has increased by 7 percentage points year-on-year to 106% in May 2013.

The banking sector maintained an adequate profitability performance in 2012 and the first seven months of 2013. Its capital adequacy ratio decreased from 16.3% in July 2012 to 15.9% in July 2013, which is still significantly above the regulatory target of 12%. The share of non-performing loans in total banking sector loans has remained broadly stable at just below 3% (2.8% in July 2013). The Financial Stability Committee, established in June 2011 under the chairmanship of the Deputy Prime Minister in charge of the economy, has monitored the functioning of the financial system, including systemic risks and their management. Parliament adopted the long-awaited Capital Markets Law, which aims at further harmonising the legislative framework in securities markets and investment services. *Overall*, the financial sector has performed well and has continued to demonstrate resilience.

5.2. THE CAPACITY TO COPE WITH COMPETITIVE PRESSURE AND MARKET FORCES WITHIN THE UNION

Existence of a functioning market economy

Turkey's growth performance in a context of global economic volatility in recent years confirms the economy's improved fundamentals and enhanced resilience to shocks. However, the large structural current account deficit and relatively high inflation indicate the persistence of significant underlying imbalances in the Turkish economy. *Overall*, the functioning of market mechanisms has remained appropriate.

Human and physical capital

The educational reform programme, which is a key component of the 2007-13 National Development Plan, is coming to an end. It sets two key priorities for education modernisation and reform: increasing the responsiveness of education to demand and enhancing the quality of the education system. Some progress can be recorded. The literacy rate increased from 88% in 2010 to 90.8% in 2011. The schooling ratios have increased at all levels of education, in particular at tertiary (university) level. Important gaps persist regarding the schooling ratios for girls, especially in secondary education. Participation in higher education remains low by international standards. The effects of extending compulsory education from 8 to 12 years as from the 2012-13 school year remain to be seen. *Overall*, reforms and increased spending on education have so far generated a positive impact on educational attainment and schooling rates, but significant problems remain with regard to gender equality and the quality of education.

Total investment decreased from 21.8% of GDP in 2011 to 20.3% in 2012, entirely due to the slump in private investments, which fell from 18.0% of GDP in 2011 to 16.4% in 2012. Public investments continued to increase and their share in GDP rose from 3.8% in 2011 to 3.9% in 2012. Gross foreign direct investment (FDI) inflows to Turkey decreased from €11.5 billion in 2011 to €7.7 billion in 2012. Although the official aim of the government is to increase expenditures on research and development to 2% of GDP, the actual outcomes remain much lower; R&D expenditure amounted to just 0.86% of GDP in 2011. Modest progress was made in the upgrading of the transport infrastructure, including a 1.9% extension of the motorway network between 2010 and 2011. *Overall*, improvements in the country's physical capital have been modest.

Sectoral and enterprise structure

While output growth had clearly outstripped employment growth in 2011, overall employment in the Turkish economy increased by 3.0% in 2012, i.e. significantly faster than output growth. The sectoral breakdown of employment growth shows a clear shift towards the services sector, the share of which in total employment went up by 1.3 percentage points to 49.4%. The proportions of total employment accounted for by agriculture, industry and construction declined to 24.6%, 19.1% and 6.9% respectively. As a proportion of GDP, services increased by 1.2 percentage points, whereas all other sectors declined.

There has been some progress in the liberalisation of the network industries. A new electricity market law entered into force on 30 March 2013 which aims at improving market competition and alignment with the *acquis*. In the market for natural gas, the energy regulator granted import licences to four private companies, increasing the private sector's market share to 20%. However, further progress is needed in the programme to liberalise the natural gas market by reducing the monopolistic market share of state-owned BOTAŞ. There was progress in the telecommunications market with the adoption of regulations to improve competition and transparency. *Overall*, the liberalisation of network industries gathered some pace.

State influence on competitiveness

The legislation implementing the State Aid Law, originally scheduled to be enacted by September 2011, has been postponed for a second time. The State Aid Authority still needs to establish a formal state aid inventory. It is also expected to enact an action plan for aligning all state aid schemes, including the 2012 incentives package, with the *acquis*. The legal framework for public procurement continued to comprise various exemptions and is still not in line with the EU *acquis*. *Overall*, there has been no progress in enhancing the transparency 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, increased from 56.6% in 2011 to 58% in 2012. The EU's share in Turkey's total trade decreased from 40.8% in 2011 to 37.7% in 2012. Its share in Turkey's exports declined particularly strongly from 46.2% to 38.8%, mainly due to depressed demand conditions in the EU and the surge in Turkey's gold exports to Iran. Its share in Turkey's imports decreased more moderately, from 37.8% to 37%. The EU remained by far the largest source of FDI in Turkey, with a share of 71.3% in 2012. Foreign capital investment inflows originating from the EU countries — excluding real estate — fell from €8.2 billion in 2011 to €5.5 billion in 2012. *Overall,* trade and economic integration with the EU remained high.

Labour productivity declined in general in 2012, with employment increasing more than twice as fast as output. For industry, where sector data are available, production per hour declined by 2.0% between the fourth quarter of 2011 and the fourth quarter of 2012. Over the same period, hourly labour costs in industry increased by 8.0%. This implies a rise in unit labour costs of around 10%. At the same time, the Turkish lira appreciated by 7.8% in real terms. *Overall*, Turkey's international price competitiveness declined significantly in 2012 due to rising unit labour costs and currency appreciation.

5.3. CONCLUSIONS

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.

Following strong growth rates of around 9% in the preceding two years, Turkish GDP growth slowed down to 2.2% in 2012. This was accompanied by a rebalancing of growth from domestic demand to foreign trade, a temporary narrowing of the current account deficit, and a decline of inflation. In the first half of 2013, GDP growth strengthened again to 3.7%. At the same time, the current account deficit has widened again and consumer prices have reaccelerated. Public debt as a share of GDP has continued to recede and is now clearly below 40%. Since May, due to domestic and global factors, financial markets have come under pressure which led to immediate reactions by the central bank with a view to stabilising the exchange rate and containing capital outflows.

Turkey's recent economic performance illustrates both the high potential and the continuing imbalances of the economy. On the external side, the reliance on sustained capital inflows to finance a large structural current account deficit makes Turkey vulnerable to changes in global risk sentiment, resulting in large exchange rate fluctuations and boom-bust cycles in economic activity. Addressing this vulnerability calls for measures to increase national saving and fiscal policy has an important role to play in this respect. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility. Relatively high inflation continues to be a major challenge. A rebalancing of the macroeconomic policy mix would be helpful to ease the burden on

monetary policy. For the medium to longer term, it is essential that the functioning of the markets for goods, services and labour is improved through structural reforms to increase international competitiveness.

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

The main political parties agree on the key essentials of a market economy, despite a tense political environment. Macroeconomic stability was broadly preserved, but vulnerabilities remain. The budget deficit exceeded the target in 2012. This led to the statutory debt ceiling of 60% of GDP enshrined in the budget law being breached and abolished. The privatisation process suffered certain setbacks. Albania submitted its seventh Economic and Fiscal Programme, for 2013-15, in January. The programme's medium-term macroeconomic scenario is optimistic. Its coverage of risks to the macroeconomic and budgetary outlook is insufficient, and the approach to addressing structural obstacles to growth lacks a clear strategy and targeted policy measures. *Overall*, the consensus on the main fundamentals of a market-oriented economy has been maintained.

Macroeconomic stability

According to preliminary data, economic growth slowed to 1.6% in 2012 from 3.1% a year earlier. Financial constraints, low confidence among consumers and investors and the presence of spare production capacity held back private consumption and investment spending. Total gross fixed capital formation decreased by around 5% in 2012 compared with the previous year. Migrant workers' remittances increased slightly, by some 1.6% in 2012, but dropped by 33% on an annual basis in the first six months of 2013. Private consumption remained at low levels. Net exports were the main contributor to economic growth, with foreign sales holding up while imports declined. After falling in four consecutive quarters, economic sentiment indicators started to climb in late 2012 and early 2013, but real GDP only grew by 1.7% in the first quarter of 2013 in annual terms, reflecting still sluggish domestic spending. Foreign demand continued to contribute positively to growth. Per capita GDP in purchasing power standards was estimated at 30% of the EU-27 average in 2012, unchanged from 2011. *Overall*, while growth remained positive, Albania experienced a slowdown in 2012 due to weak private domestic spending, which also extended to the first quarter of 2013.

External imbalances improved, as exports proved resilient while weak domestic demand depressed imports. The current account deficit narrowed to 10.5% of GDP in 2012 from 13% a year earlier on the back of a contracting (but still large) trade deficit. Imports fell by 5.2% compared with the previous year. Exports grew by a marginal 0.9%, as an 8.5% increase in merchandise exports was largely offset by a fall in services export. The effect of the improved trade performance outweighed negative changes in the income and current transfer balances. The trend towards a narrowing trade deficit continued in the first seven months of 2013 when merchandise exports, driven by a buoyant energy sector, expanded by 18.4% in annual terms, while imports of goods declined by 5%. The current account deficit stood at 10.1% of GDP in the four quarters to June.

Net foreign direct investment (FDI) inflows remained at the same level in 2012 as in 2011 and financed some 70% of the current account deficit, up from 60% in 2011. Total capital account inflows fell by 11.3% on an annual basis in 2012, but the overall balance of payments was positive and the stock of international reserves increased by 4.2%, covering about 4.5 months of imports. In the first half of 2013, FDI inflows increased by 12.3% in annual terms. *Overall*, the current account deficit has

been narrowing but remains a source of vulnerability, especially in view of the potential adverse impact of the volatile external environment on inflows of FDI and migrant workers' remittances.

Labour market conditions improved somewhat during 2012, but the registered unemployment rate remained high at 13% on average, down slightly from 13.4% in 2011. Employment grew by 2.8% both due to more private-sector, non-agricultural jobs and a higher estimated number of employees in the agricultural sector. In the first half of 2013, unemployment remained stable at 12.8%. Long-term unemployment accounts for around two thirds of total jobseekers, reflecting its structural nature. Labour market statistics continue to be weak and are distorted by a large informal sector. *Overall*, there was a slight improvement in the labour market but the informal sector remains large and unemployment is persistently high.

Table 6.1:
Albania - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	7,5	3,3	3,8	3,1	1.6e	1,4
Private consumption	Ann. % ch	9,8	6,2	5,7	7,2	8,0	N.A.
Gross fixed capital formation	Ann. % ch	12,9	-2,3	-1,3	4,2	-4,7	N.A.
Unemployment	%	12,8	13,6	13,7	13,4	12,9	12,8
Employment	Ann. % ch	2,9	-5,9	-0,1	2,3	3,6	1,4
Wages, public sector	Ann. % ch	8,3	11,9	6,7	7,0	7,3	5,9
Current account balance	% of GDP	-15,5	-15,3	-11,5	-13,0	-10,8	-10,4
Direct investment (FDI, net)	% of GDP	7,5	8,2	8,9	8,1	7,9	8,0
CPI	Ann. % ch	3,4	2,3	3,6	3,5	2,0	2,4
Interest rate (3 months)	% p.a.	6,24	N.A.	N.A.	N.A.	5,16	4,91
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate LEK/EUR	Value	122,39	131,82	137,48	140,07	138,83	140,02
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-5,5	-7,0	-3,1	-3,6	-3,5	-3,5
General government debt	% of GDP	54,8	59,5	58,5	60,3	62,9	64,1

* Q1
Sources: Thomson Reuters/Ecowin, Eurostat

Macroeconomic stability continued to be enhanced by a sound monetary policy, which was successful in keeping inflation low and anchoring inflation expectations. The average inflation rate decelerated from 3.5% in 2011 to 2% in 2012, which corresponds to the lower end of the Bank of Albania's (BoA) target range of 2-4%. Low inflation reflected the negative output gap, well-anchored inflation expectations and the absence of supply-side shocks. Driven mostly by fluctuating food prices, annual inflation decelerated from 2.5% in the first quarter of 2013 to 2.2% in the second quarter. In the absence of inflationary pressures and in an effort to stimulate growth, the BoA undertook several cuts in the key interest rate, bringing it to a historic low of first 3.75% in January and subsequently to 3.5% in July. The rate cut was swiftly reflected in interbank rates, the primary market for government security and also in deposit rates. However, the pass-through to lending rates remains limited due to increased risk premia amid a growing share of non-performing loans.

The degree of euroisation of the financial system has slightly decreased but remains high. Foreign, mostly euro-denominated loans stood at 61% of total credit outstanding in July, down from 64% a year earlier, while the share of foreign currency-denominated deposits in the total deposit stock fell from 49% to 47% in the same period. Such high euroisation inhibits monetary policy's effectiveness and could expose banks to currency mismatches or indirect credit risks; it is therefore a potential source of instability in the financial system.

Albania maintains a floating foreign exchange regime, unchanged since 1992. The Albanian lek continued to remain stable in 2012, marking a slight appreciation by 0.9% against the euro. In the second quarter of 2013, the Albanian currency depreciated slightly against the euro by around 1%

year-on-year. *Overall*, monetary policy remained sound, inflation decelerated and exchange rate stability was broadly preserved.

The government deficit reached 3.4% of GDP in 2012, exceeding the 3% target in the initial budget but remaining slightly lower than the 2011 deficit of 3.5%. Disappointing revenue performance meant that new budgetary targets had to be set by the November Normative Act. Overall, revenues underperformed by some 7% in 2012 compared with the initial budget, as the largest items, VAT and excise tax revenues, fell significantly short of the initial targets, reflecting sluggish domestic demand. Revenue slippages were only partly offset on the expenditure side, where the largest cuts affected capital spending, down by some 12% compared to the initial target and by the same order of magnitude compared with 2011. In the wake of weak revenue collection, the total-revenue-to-GDP ratio fell to 24.5% from 25.1% in 2011, while the total-expenditure-to-GDP ratio fell to 28.0% in 2012 from 28.6% a year earlier. Public capital expenditure accounted for just 4.6% of GDP compared to 5.4% in 2011.

The fiscal stance in 2013 is more expansionary. The 2013 budget envisaged a deficit of 3.5% of GDP, based on an optimistic assumed economic growth of 3.1%. The fiscal deficit (without the receipt from the privatisation of three hydro-power plants) in the first seven months was almost 130% higher than in the same period of the previous year, reaching some 98% of its full year target. In the period January to July, revenue from indirect taxes declined significantly, reflecting still fragile domestic demand, lower imports and the effect of recent VAT exemptions. Expenditure was 10.4% higher than in the same period the year before, mainly due to the rapid increase in capital expenditure. *Overall*, budgetary planning continues to be weak, reflecting optimistic revenue projections and leading to the need for rebalancing.

Public debt increased from 59.4% of GDP in 2011 to 62.9% by the end of 2012, exceeding the statutory ceiling of 60%, which was abolished in December. Some three fifths of the public debt is domestic but it continues to show a short-term bias (around half of it has a maturity of one year or less) which requires frequent re-financing. Households’ share of purchases of public debt securities continued to increase, but the bulk of the domestic debt is still held by banks, which could pose a challenge if they decide to reduce their government debt holdings and also exposes banks to sovereign risk. Although the weighted average yield on domestic debt has been gradually decreasing, at such a high level, public debt remains a source of macro-financial vulnerability. The estimated large amount of public sector arrears continue to represent additional government liabilities, leading to financial difficulties along the credit chain and contributing to the high level of non-performing loans. *Overall*, the relatively high and increasing government debt and its short-term bias are a cause for concern, as they represent a source of macro-financial vulnerability, especially following the abolition of the statutory debt ceiling. The accumulation of public arrears reflects serious weaknesses in public finance management.

In the area of tax administration, there were improvements in the electronic tax payment and tax filing system, but the effects on tax collection remain to be seen. Measures have also been adopted to exempt imports of machinery, equipment and raw materials used for certain investments from VAT, and to introduce a non-taxable income limit for personal income tax. Delays in the VAT refund procedure continue to put an additional burden on businesses.

Overall, macroeconomic stability has been maintained. Low inflation and anchored inflation expectations created room for monetary policy easing, but the pass-through to the economy remains limited. The fiscal stance in 2013 is expansionary, contributing to a further increase in the relatively high level of public debt, which remains a source of macro-financial vulnerability. Fiscal planning and predictability remain a concern, especially following the abolition of the debt anchor. Unemployment remains high. External imbalances have narrowed but are still high, reflecting persisting structural weaknesses.

Interplay of market forces

The private sector remains dominant and continues to account for about 80% of GDP. The privatisation process suffered setbacks with the unsuccessful sale of Albpetrol, a state-owned oil company, and of the remaining public stake in Albtelecom, a partly privatised telecommunication firm. No progress was made on the privatisation of INSIG, the state insurance company. The previously privatised power distributor CEZ Shpërndarje returned into state hands after the energy regulator revoked its distribution licence and appointed an administrator, on the grounds that the Czech-owned company had failed to meet contractual obligations. The dispute will be settled by international arbitration.

There has been some progress as regards attracting greenfield investment in the energy sector with 11 new agreements signed in 2012 to construct and operate hydropower plants (HPPs). The output of privately-owned small HPPs surged by 76% year-on-year in 2012, raising their share of total electricity generation to 5.6% in 2012, from 3.4% a year earlier. In February the privatisation of three small HPPs was completed, for a total of €109.5 million. *Overall*, state involvement in the economy remains limited and is mainly concentrated in water supply, transport and energy.

Market entry and exit

Business registration and licensing continued to perform well through the established network of one-stop shops. Some improvement was made to the business registration system by making the notarisation of incorporation documents optional. In 2012 the number of new businesses registered grew by 8% year-on-year; they make up 12% of all active enterprises.

A registry of certified bankruptcy administrators was set up and 23 bankruptcy administrators were licensed until April. However, the time taken and procedures for market exit remain slow. In 2012 the number of requests for voluntary business closures went up by 14% from a year earlier. *Overall,* Albania has made incremental improvements to its well-functioning procedures for starting a business. Market exit procedures remain slow.

Legal system

In the area of property rights implementing legislation on registration of immovable property has been adopted. However, first registration of properties is yet to be completed. Further efforts are also needed in the area of property restitution and compensation and in the legalisation of buildings that did not have permission. Amendments to the Civil Procedure Code were adopted in April to allow easier recovery of collateral. Cases of collateral recovery rose significantly in 2012, along with the number of private bailiff offices. However, the full impact of the new legal measures has yet to be assessed. *Overall*, there has been some progress in the legal system but proper implementation needs to be ensured. Uncertainties over property ownership, delays in court procedures and weaknesses in the rule of law continue to be detrimental to the business environment.

Financial sector development

The banking sector continued to dominate the financial system, accounting for 93.6% of all financial system assets and 87.9% of GDP — 3 percentage points higher than in 2011. It is dominated by foreign capital and remains highly concentrated, with the five largest banks holding about 68% of the total credit portfolio and 74% of total deposits. Total credit to the economy amounted to around 41% of GDP, suggesting that there is significant scope for deeper financial intermediation. Credit growth fell to 7.4% in 2012 from 11.7% in 2011, and has recently fallen faster, with annual credit growth at 1.6% in the first quarter of 2013 and just 0.7% in the second quarter.

Weak lending, affecting both households and investors, reflects tighter credit standards applied by banks amid a high and rising share of non-performing loans and subdued credit demand due to economic uncertainties. In an effort to reinvigorate lending, the BoA adopted specific regulatory changes in March aiming at releasing financial resources for banks and channelling them towards lending to the private sector, but so far credit growth has not picked up.

In general, the Albanian banking system remained well capitalised and liquid. The net results of the banking system in 2012 amounted to €26.71 million, reflecting a significant increase compared with the previous year. The capital adequacy ratio increased to 16.7% in May from 15.6% at the end of 2011, with each individual bank remaining above the 12% regulatory minimum. The ratio of liquidity assets to short-term liabilities as of the end of December 2012 increased to 36.7%, comfortably exceeding the minimum regulatory requirement of 25%. Deposits were the main source of financing and parent-bank credit lines were significantly lower than at the end of 2011, strengthening the banking system's resilience to foreign shocks. However, banks' exposure to credit risk has increased, as the ratio of non-performing loans rose further to 24.4% in the second quarter of 2013 compared to 21.2% a year earlier. This has led to a surge in loan loss provisioning, up by 24.3% in June on an annual basis.

Total assets of the non-banking financial sector stood at 2.8% of GDP. The insurance market, in which foreign capital has a 50% stake, increased its gross written premium revenues by some 9% in 2012 but its share of GDP remains low. The securities market focused on government bonds and saw two new investment funds start up. The voluntary pension market grew by 83% in 2012 from a very low base and is still in the very early stages of development. The BoA continued to strengthen the regulatory and supervisory framework. It adopted regulations on the core management principles of banks and foreign bank branches; on the licensing of non-banking financial institutions; on risk-management of non-banking financial institutions; and on e-payment instruments. *Overall*, the banking system remains well capitalised and liquid. However, non-performing loans remain a cause for concern, while the sharp deceleration of credit growth is detrimental to the economy.

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. The economic slowdown resulted in a shrinking current account deficit, but external imbalances are still large, reflecting a narrow production base. Low inflation reflects the lack of inflationary pressures and well anchored inflation expectations. Fiscal policy remains constrained by the relatively large and growing public debt, much of which is short-term and thus reinforces vulnerability. Fiscal planning continues to be weak and its predictability has deteriorated following the abolition of the debt anchor.

Structural bottlenecks are an obstacle to growth. Despite some progress, weaknesses in property rights and law enforcement continue to be detrimental to the business environment. The labour market is characterised by persistently high unemployment. The privatisation process is advanced but not yet complete. The diversification and competitiveness of the economy are still low. *Overall*, although some progress was made on establishing a functioning market economy, Albania needs to consolidate its public finances and reduce the relatively high level of public debt, further bolster governance, enhance labour market performance, provide protection for property rights and strengthen the rule of law and the fight against corruption.

Human and physical capital

Public expenditure on education is estimated to have accounted for around 3.2% of GDP in 2012 and is expected to be unchanged in the 2013 budget. New learning standards and syllabuses were introduced in secondary education. Public spending on research and development remained at low levels, at 0.03% of GDP in 2012 and 2013. The number of science laboratories increased in 2012. The level of collaboration between industry and universities remains weak.

Public capital expenditure bore the burden of the budget rebalancing and shrank by 12.8% in 2012, accounting for just 4.6% of GDP compared to 5.4% in 2011. It is projected to make up 5% of GDP in 2013. The authorities identified education, healthcare, infrastructure, and agriculture as priority areas, but spending plans project a decline in public investment in these sectors in 2013. Road infrastructure remains the main beneficiary of public investment. According to estimates, total investment spending in the economy declined by around 5% in 2012 and decreased as a share of GDP from about 32% in 2011 to 29.3%.

Albania remains highly dependent on hydroelectric resources to ensure security of power supply. No progress was made in increasing interconnection capacity with other countries. Preparations for the construction of the interconnection with Kosovo were re-launched in January. Albania was able to export electricity at the beginning of 2013 due to favourable weather conditions but continues to be a net importer of electricity. The number of concessions signed in the energy sector increased, while several irregularities in concession procedures were identified by the Supreme State Audit Institution.

Overall, there is significant scope for redirecting investment into growth-enhancing areas such as telecommunications and human capital, and for better-focused policies promoting innovation initiatives and cooperation between the education sector and industry.

Sectoral and enterprise structure

The Albanian economy continues to be dominated by the services sector, which accounted for around 60% of gross value added (GVA) in 2012, followed by agriculture, providing around a fifth of GVA, and industry (11%), comprising both extractive industries and manufacturing. Manufacturing relies to a large extent on the low value-added textile, garment and leather industries. Following a deep contraction by about 13% in 2012, the construction sector’s share of GVA fell to below 9%. Agriculture continues to provide a very large proportion of jobs (around 50%), suggesting that there is still significant scope for productivity gains from sectoral shifts in employment.

The sectoral composition of merchandise exports remained highly concentrated in 2012, with 84% of total exports accounted for by minerals, fuels and electricity (36%), textiles and footwear (29%) and construction materials and metals (19%). The minerals, fuels and electricity sector increased foreign sales by some 31% compared with 2011.

Small and medium-sized enterprises (SMEs) play a very important role in the economy, providing 71% of official employment, although weaknesses in their operational environment persist. In the non-agricultural sector, SMEs account for 47% of exports and 68% of value added.

Significant weaknesses continued to prevail in the electricity sector in terms of a lack of financial viability, high levels of losses in the electricity network and distribution, low bill collection rates and tariffs below cost-recovery level. Dependence on hydropower continues to pose a substantial risk to the country’s electricity supply.

The sizeable informal sector remains a substantial problem and is detrimental to the business environment. The number of fiscal devices (cash registers) installed by businesses increased, but the

system for monitoring their use in practice needs to be strengthened. The number of suspected corruption cases referred to the prosecutor’s office by customs and tax investigation units increased. *Overall*, the structure of the economy remained unchanged. Albania’s production base lacks diversification in terms of both sectors and export markets, leaving the economy vulnerable to industry-specific shocks. Malfunctioning persists in the electricity sector. The size of the informal sector remains a challenge.

State influence on competitiveness

The ratio of state aid to GDP increased to 1.6% in 2012 from 1.3% the year before, with less distortive horizontal (i.e. non sector-specific) aid continuing to account for the bulk of state aid granted. Similarly to the previous year, the government provided a loan guarantee to the state-owned power generation company KESH to help it survive financial difficulties in late 2012 and early 2013. The unresolved problems of the electricity sector are an enduring drain on public resources.

Economic integration with the EU

Albania’s openness to trade decreased somewhat in 2012, as the sum of total imports and exports accounted for 87% of GDP in 2012 as compared with 92% in 2011, mainly on account of declining imports following the economic slowdown. The EU remains Albania’s main trading partner. Exports of goods to the EU increased by 13.4% compared with 2011 and accounted for some 75% of total merchandise exports, while imports of goods from the EU fell by 5.1% and made up 62% of total imports. From January to July, the trend towards a narrowing trade deficit with the EU continued as exports of goods to the EU surged by 18.8% over the previous year, while in the same period merchandise imports from the EU declined slightly. Italy remains the single most important trading partner, drawing more than half of Albanian merchandise exports and providing a third of its imports. The EU also remains the main source of inward investment in Albania, although its share of total FDI stock has declined in the last four years. The pace of the increase in trade with CEFTA countries slowed, from some 27% in 2011 to around 3% in 2012, reflecting the overall deceleration of economic activity in the region. CEFTA countries accounted for some 13% of Albanian merchandise exports and 8% of its imports. The positive trend in net exports was supported by recent changes in the real effective exchange rate (REER), showing a moderate depreciation of the lek both in the last quarter of 2012 (by 0.91%) and the first quarter of 2013 (by 0.55%). *Overall,* the EU remained Albania’s leading trade and investment partner. The pace of trade integration with CEFTA countries slowed.

6.3. CONCLUSIONS

As regards the economic criteria, Albania made some further progress towards becoming a functioning market economy. Albania should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it accelerates structural reforms.

Albania has maintained macroeconomic stability. GDP growth decelerated but remained positive mainly due to external demand. Low inflation created room for monetary policy easing to stimulate growth, but its transmission to the real economy is yet to be seen, as credit growth slowed amid high and rising non-performing loans. The budget deficit remains high and public debt increased further, leading to the statutory debt ceiling of 60% of GDP being breached and abolished. There was a slight improvement in the labour market but unemployment remains high. The current account deficit has narrowed but remains large. The economy remains vulnerable to both domestic structural weaknesses and global economic volatility.

Albania needs to complement stability-oriented fiscal and monetary policies with structural reforms to ensure long-term sustainable economic growth. Albania will have to address the high levels of budget

deficit and public debt and its short term bias. Moreover, it will need to improve fiscal predictability by reducing the recurrent overestimation of revenues and by collecting taxes more efficiently. Improving the business and investment environment is essential for diversifying the economy and boosting its long-term growth potential. This could, inter alia, be achieved by reinforcing the rule of law, tackling corruption and addressing payment arrears, as well as developing infrastructure and enhancing human capital. The informal sector remains an important challenge.

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

The consensus between the authorities at different government levels on the economic policy essentials has somewhat strengthened following the agreement on a medium-term countrywide fiscal framework. The performance under the International Monetary Fund (IMF) Stand-By Arrangement remained broadly satisfactory until June 2013 when the IMF Board approved the third review. The scope of the budgetary support operation planned by the World Bank has been narrowed due to the slow implementation and lack of tangible outcomes of legislated reforms in the area of cash transfers. A loan totalling €100 million under the EU macro-financial assistance instrument has been disbursed in two equal tranches in February and September, respectively, after a delay of one year and following a satisfactory compliance with the attached economic policy conditions. In January 2013, the authorities submitted their seventh Economic and Fiscal Programme, covering the period 2013-2015, which foresees gradual economic recovery and simultaneous fiscal consolidation. Its macroeconomic scenario appears optimistic, while the fiscal and structural reform strategies remain fragmented and do not present a coherent nation-wide formulation of economic and fiscal policies. *Overall*, despite some slight improvement, the consensus on economic and fiscal policy essentials remains weak.

Macroeconomic stability

In 2012, the economy contracted by an estimated 1.1%, following a mild recovery in the previous two years. The deterioration was due to negative developments in both domestic and external demand. Private consumption fell in 2012 due to falling real wages and employment and decelerating growth of retail lending. At the same time, the worsened external environment resulted in falling exports, which combined with stagnating imports led to a negative contribution of net exports to growth. Industrial production fell by 5.3% in 2012, compared with 5.9% expansion in the previous year. A mild economic recovery started in early 2013. Industrial output growth in the first seven months of 2013 averaged 6.8% year-on-year and merchandise exports rebounded markedly by close to 8.5%, reflecting stronger economic activity, but also base effects. Per capita income, measured in purchasing power standards (PPS), decreased in year on year comparison at 28% of the EU-27 average in 2012 from 30% in 2011. *Overall*, following a slight contraction in 2012, the economy started to recover in early-2013.

After a significant deterioration in 2011, the current account deficit grew only marginally by 0.9% year on year, reaching 9.5% of GDP in 2012. The trade deficit increased by 1.2% and reached 32.7% of GDP, as exports fell by 1.9%, while imports stagnated. The surplus in services fell slightly for a second consecutive year, thus contributing once again to a higher current account deficit. At the same time, the surpluses in the net current transfers and income accounts increased by 2.3% and 8.1%, respectively, thus partially offsetting the negative developments in the goods and services balances. In the first half of 2013, rather favourable trade developments supported a further narrowing of the current account balance.

The current account deficit in 2012 was financed mainly by external borrowing and, to a lesser extent, by foreign direct investment (FDI). As a share of GDP, net FDI increased to 3.5% in 2012, but remained well below pre-crisis levels. In the first six months of 2013 net FDI almost tripled compared

to the same period a year before. Following a significant decline in the first half of 2012, the net foreign exchange reserves recovered in the second half of the year, positively influenced also by the drawing of two tranches under the Stand-By Arrangement with the International Monetary Fund. The stock of official foreign exchange reserves increased slightly by 0.6% in 2012 and rose further by 6.6% year on year in the first seven months of 2013, covering around six months of imports. Bosnia and Herzegovina's external public debt increased by 7.4% to 27.5% of GDP in 2012, while external private debt fell slightly over the year and reached 32.2% of GDP. In the first half of 2013, the external public debt rose further by 5.8% year on year. The World Bank group remains the largest creditor, while public international creditors account for over 90% of the country's external public debt. A large part of the debt is contracted on concessional terms with the average interest rate of all debt being at only 1.44%. *Overall*, despite some improvements in 2012 and the first half of 2013, external imbalances still remain elevated. The financing of the deficit increasingly relied on foreign loans, leading to an increase in public gross external debt.

Unemployment remains very high and reached 28.6% in 2012 from 28% a year earlier. Total employment levels stagnated through 2012 and marginally decreased (- 0.6%) year on year in the first half of 2013. Some employment gains in services and in the public sector could not compensate for continued labour shedding in large parts of the private sector, in particular in construction, mining and agriculture. The number of employees in the public administration continued to rise throughout 2012 and the first half of 2013, thus further increasing the size of the already large public sector. . Unemployment was particularly high among the young population (63.1% for people aged between 15 and 24). The very high unemployment rate and the sizeable difference between the registered and survey-based labour figures suggest the existence of a fairly large informal labour market and significant structural rigidities, such as high rates of social security contributions, high labour taxes, and poorly targeted right-based benefits. Adjusted for inflation, the average gross wage fell by 0.5% in 2012 and dropped further by 1.7% in the first half of 2013. *Overall*, labour market conditions have remained difficult and structural rigidities have continued to hamper job creation.

Table 7.1:
Bosnia and Herzegovina - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	5,6	-2,8	0,7	1,0	-1,1	N.A.
Private consumption	Ann. % ch	5,5	-4,6	0,1	1,6	-0,8	N.A.
Gross fixed capital formation	Ann. % ch	5,3	-16,8	-12,2	7,9	1,5	N.A.
Unemployment	%	40,6	42,7	42,7	43,8	45,9	44,6
Employment	Ann. % ch	2,7	-2,8	1,9	-1,6	0,1	-0,6
Wages	Ann. % ch	16,6	8,2	1,1	4,4	1,5	-0,2
Current account balance	% of GDP	-14,2	-6,6	-6,2	-9,9	-9,5	-8.1
Direct investment (FDI, net)	% of GDP	5,3	1,4	2,1	2,6	2,0	2,9
CPI	Ann. % ch	7,4	-0,4	2,1	3,7	2,1	0,8
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	2.251	1.038	954	979	737	776
Exchange rate BAM/EUR	Value	1,94	1,94	1,93	1,93	1,93	1,94
Nominal eff. exchange rate	Index	100,0	104,1	103,7	104,6	105,6	106.1*
General government balance	% of GDP	-2,2	-4,4	-2,5	-1,3	-2,1	0,7
General government debt	% of GDP	N.A.	N.A.	39,3	40,5	44,0	N.A.

* Q1
Sources: Thomson Reuters/Ecowin, Eurostat

Inflation pressure eased in 2012 and early-2013. Average annual consumer inflation moderated to 2.1% in 2012, as compared with 3.7% in 2011. The main factors behind the lower inflation were the decelerating food and transport prices, reflecting international price developments. The disinflationary trend continued in 2013, with annual inflation reaching 0.5% in July, mainly driven by price moderation in food, housing and transport. Price decreases were recorded in clothing and footwear and health, while on the other hand, the new hike of excises on tobacco, effective from the beginning

of 2013, resulted in an 8.2% rise in tobacco prices. 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 have remained unchanged. The growth of money supply moderated in the course of 2012 and monetary aggregate M2 increased by 3.4% at end of the year, as compared with a 5.8% rise in 2011. *Overall*, the currency board has continued to function well and monetary and financial stability have been preserved while inflation has moderated.

Following several consecutive years of fiscal consolidation, fiscal imbalances have grown again in 2012 and 2013, in parallel with the worsened external environment and the downturn in economic activity. The consolidated budget deficit increased to 2.1% of GDP -as compared with 1.3% in 2011-, due to higher expenditure growth (2.4%) which outstripped the rise of total revenue (0.9%). The share of general government in GDP remained relatively high, with government expenditure at approximately 45% of GDP and revenue at about 44% of GDP. Social security contributions – accounting for over 1/3 of the overall revenues – stagnated in year on year comparison. In the meantime, all main expenditure categories increased during the year indicating some loosening of the fiscal policy. Purchases of goods and services grew by 3.2%, while expenditures on social benefits increased by 1.5% and on wages declined by 0.4%, thus marginally decreasing their very high shares in overall expenditure. The composition of public spending remained highly unfavourable as current expenditure represented a very high 95% of total expenditures, while capital spending remained extremely low despite a 22% nominal increase over the previous year. Fiscal imbalances widened in the first quarter of 2013 mainly on the back of lower than budgeted revenues from indirect taxes, largely due to unexpectedly high VAT refunds. Lower revenues were partly compensated for by lower current spending (e.g. on wages) and by delays in the implementation of some public investment projects. The rebound of economic activity was felt in the public finances in the second quarter of 2013. On the other hand, the highway and road funds of both entities increased capital spending. The general government balance in the first six months of 2013 turned positive and amounted to 0.4% of annual GDP. *Overall,* the fiscal situation worsened in 2012 but improved slightly in the first half of 2013, amid a persistently low quality of public finances. The composition of public spending remains a concern. Public finance management has been somewhat strengthened and important long-delayed reforms have been initiated. The adoption of the Global Frameworks for Fiscal Policies 2013-2015 and 2014-2016 and despite a certain delay of the approval of the latter -after the lack of a medium-term fiscal programme at country level for a couple of years- improved fiscal coordination. The State and the Entities adopted their 2013 budgets before the expiration of the previous budget year. This was a welcome improvement compared with previous practices of late budget laws endorsement and temporary fiscal arrangements, which weakened the reliability of public finances and the planning and decision-making of economic agents. Some steps have been taken towards strengthening the sustainability of public finances in the Federation of Bosnia and Herzegovina. The Entity government has adopted in June 2013 a new organic budget law, introducing fiscal rules and providing for the establishment of a fiscal coordination body. The Federation Parliament endorsed in April 2013 a new law on privileged pensions providing for a comprehensive system that is financially sustainable and socially fair. Aiming to improve the long-term sustainability of the Entity's public finances, the Federation government has endorsed in September 2013 a strategy for contributory pension system reform. However, the quality of fiscal reporting remains low, thus impeding proper analysis and policy design. *Overall*, the sustainability and credibility of fiscal policy in Bosnia and Herzegovina have been somewhat strengthened but significant further efforts are still needed.

General government debt, albeit still at a relatively moderate level, kept on growing. After rising for a fourth consecutive year already, it exceeded 44% of GDP at end-2012 as compared with 40.9% of GDP a year ago. This was entirely due to external public debt, expanding by 7.4% to a total of 27.9% of GDP, while domestic debt fell slightly in the course of 2012. Both Republika Srpska and the Federation continued issuing short-term treasury bills and long-term government bonds to finance budget deficits and debt repayment obligations. In most occasions, the offers have met relatively high

demand and secured relatively favourable conditions. Public debt servicing soared over twofold in recent years and reached over 3% of GDP in 2012. *Overall*, even though the debt-to-GDP ratio is still relatively moderate, its upward trend needs to be monitored carefully.

Overall, financial and monetary stability have been preserved as the low inflation environment was maintained and the currency board arrangement continued to enjoy a high level of confidence and credibility. However, rising fiscal deficit, substantial external imbalances as well as very high unemployment continue challenging the overall macroeconomic stability.

Interplay of market forces

The private sector's share in GDP is estimated to have remained broadly unchanged at around 60% of GDP in 2012. There has been no further progress with the privatisation agenda for a fifth consecutive year. In Republika Srpska, about 2/3 of the enterprises intended for privatisation have been sold already prior to the crisis, while some of the companies that were previously offered for sale and were not privatised were forced to declare bankruptcy. In the Federation, slightly over 40% of the initial stock of state-owned capital intended for privatisation had been sold by May 2013, unchanged from a year earlier. Most prices are liberalised, even though a number of regulated prices remain (e.g. for utilities). *Overall*, the privatisation process which has stalled during the crisis period has not advanced in 2013.

Market entry and exit

Companies are still required to register in both Entities before they can do business in the whole country. In Republika Srpska an ambitious reform -embracing amendments to 20 legal acts in the entity- introducing a one-stop-shop business registration system has been launched targeting significant reduction of registration time (from 23 to 3 days), number of required procedures (from 11 to 5) and business start-up costs (from €500-750 to €200). In the Federation, a new Law on Companies -enabling simplification and improvement of the business registration process in terms of reduction of time and streamlined processes and lowering the level of establishing capital- has been adopted in September 2013. In the first half of 2013, alongside the improved external environment and increased economic activity, the number of newly registered companies increased by 3.7% year-on-year. Slow contract enforcement, limited access to financing, and political instability are considered to be among the most problematic factors for doing business in the country. No progress has been made in the field of market exit. *Overall*, business registration system has been somewhat simplified but significant administrative barriers remain for private-sector development.

The legal system

No substantial improvements can be reported as regards the legal system in Bosnia and Herzegovina, which remains complex and challenging. The standard of legislation is relatively high in some areas; nevertheless the practical implementation of laws is often poor due to the weak enforcement capacity of key institutions. The judicial system often does not function efficiently and does not cover commercial activities adequately. Enforcement of commercial contracts remains a lengthy process, which involves 37 procedures and takes an average of 595 days, unchanged from the previous year. *Overall*, a weak rule of law, corruption, and unreliable contract enforcement continue to hamper the business environment.

Financial sector development

The financial system of Bosnia and Herzegovina remained dominated by the banking sector holding about 84% of total assets in 2012. The share of claims on the private sector in relation to GDP decreased marginally year on year to about 56% in July 2013. Twenty-eight banks are operating in the

country in 2013, compared with twenty-nine a year ago, as one bank's license was revoked in early-2013. There is one majority State-owned bank, while the rest are privately owned. Nineteen banks are under foreign ownership, accounting for slightly below 90% of the total banking system assets in 2012. Banking sector assets rose by 2.8% (July 2013 compared with July 2012), accounting for approximately 88% of GDP.

The financial position of domestic banks has improved. The total net revenues of the banking sector surged to €91.8 million in 2012. However, banking profitability remained broadly unchanged in the first half of 2013 with the return on average equity and the return on average assets staying at 4.2% and 0.5%, respectively as of end-June 2013. The quality of the loan portfolio deteriorated further reaching alarmingly high levels. The share of non-performing loans soared by 1.6 percentage points year on year to 14.3% in the second quarter of 2013. The capital adequacy ratio increased to 17.7% in the second quarter of 2013 up from 16.7% a year earlier, comfortably above the legal minimum of 12%. Liquidity indicators deteriorated during the same period with the ratios of liquid to total assets falling from 24.8% to 24.1% and of liquid assets to short-term financial liabilities from 43.5% to 42.2%. Twenty-six banks are participating in the deposit guarantee scheme. Its coverage level remained unchanged at around €18 000. *Overall*, despite the elevated and further rising non-performing loan ratio, financial stability was safeguarded.

The financial sector has not been very supportive to growth in 2012 and early-2013. Annual total credit growth moderated from 5.6% in 2011 to 4.9% at the end of 2012 and went further down to 2.5% year on year in July 2013, with total loans accounting for about 63% of GDP. Corporate lending has been stagnating throughout 2012 but there were signs of recovery in early-2013 as it grew by 2% year on year in July 2013. Retail lending has been moderating throughout the whole period and posted only a marginal growth of 1.8% in July 2013. Private sector credit may have been negatively affected by the high financing needs of the government, even if the magnitude of the potential crowding out is likely to be rather limited, given the relatively low share of government sector in total credits. The recovery of deposits continued though at further moderating rates. Total banking deposits reached 53.1% of GDP in July 2013. Households remained the main contributors to this development, increasing their savings by 8.3% year on year. The total loans-to-deposits ratio slightly moderated to 118.4% in July 2013. *Overall*, the financial sector has not been very supportive to growth, partially due to some crowding out.

The downward correction on the two stock markets in Bosnia and Herzegovina continued. The combined turnover of the bourses soared over twofold year-on-year, mainly influenced by the placed T-bills issues of both entity governments. The combined market capitalisation inched up to approximately 33% of GDP from around 30% a year ago. The insurance sector remained small, accounting for approximately 2.1% of GDP in 2012. The annual growth of premiums accelerated slightly to 3.5% in 2012 from a 3.4% annual rise in 2011. The market was dominated by the non-life insurance segment, which accounted for 84.9% of the total. Twenty-six companies were operating on the market in 2012, up from twenty-five in the previous year. *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

The quality of public finances remains low, even though public finance management has been somewhat strengthened and some steps have been taken to improve public finances sustainability, in particular in the Federation. Unemployment remains very high. The stalled privatisation process, along with the prevailing obstacles to private-sector development and the unfavourable composition of

budgetary expenditures continue to undermine a more growth-oriented allocation of resources. No progress has been made towards creating a single economic space within the country. *Overall*, the functioning of market mechanisms remains hampered by the large government sector, characterised by low spending efficiency and sizeable interference in the economy.

Human and physical capital

Information and statistics on human capital remains scattered and scarce, thus preventing effective policy-making. Although enrolment rates in higher education increased slightly in the 2012-2013 academic year, progress in the field of education has been very limited. The new coordination format for education reform, which had been agreed in 2012, is not effective as the Conference of the education ministers in Bosnia and Herzegovina, foreseen to be held every second month, met twice since March 2012. No progress has been made with regard to one of the major bottlenecks of the education system, namely the mismatch between the qualifications needed on the labour market and the profile of graduates coming out of the education and vocational training systems. Participation in the labour market is still very low, with an activity rate of 43.6% in 2013, as compared with 44% in the previous year. *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.

The investment-to-GDP ratio remained at relatively low level of about 20.3% in 2012, slightly increasing in year on year comparison. Net FDI flows surged by 70.6% – albeit from a very low level –, reaching 3.5% of GDP. The structure of FDI inflows improved slightly with rising green-field investments in tradables (manufacturing industry, in particular) at the expense of the financial sector. Some progress, however slow, can be reported in the improvement of the road and rail infrastructure on the Pan-European corridor Vc. A number of projects of rehabilitation of road and railway infrastructure are being implemented. Maintenance and upgrading of roads continued, but progress was slow. *Overall*, despite the difficult external environment the country seems to have gained some attractiveness towards foreign investors. Infrastructure improved slightly, but still requires repairs and modernisation.

Sector and enterprise structure

Market liberalisation remains insufficient in many sectors as most utility providers still do not apply market prices. No progress has been made on unbundling electricity networks. There was some slight progress towards a competitive telecommunications market. New licences were granted for internet services and network operators. The level of broadband internet access has increased marginally remaining at relatively low level of 11.2%. *Overall*, limited progress was achieved on liberalisation of network industries.

There were no major shifts in the sectoral structure of the economy in 2012. Services accounted for 71.2% of gross value added (*up* from 68.4% in 2011), industry for 20.1% (21.8%) and agriculture for 7.7% (8.4%). The share of construction fell for a fourth consecutive year reaching 4.9%. The traditionally high share of public administration, education and health increased slightly to 23.3%. The large informal sector which is fuelled by weaknesses in tax and expenditure policies and in law enforcement, including the fight against corruption, remains an important challenge. *Overall*, there have been no major changes in the structure of the economy. The informal sector is an important challenge.

State influence on competitiveness

No progress has been made in reducing the state’s influence in the economy. Direct budget subsidies to industry and agriculture increased to 1.6% of GDP in 2012, *up* from 1.5% in the previous year. In the first quarter of 2013, they decreased 21.3% year on year. Despite the establishment of a state aid

authority and the appointment of a secretariat, both are not fully operational as implementing legislation and budget remains to be adopted. Transparency of all state aid granted in Bosnia and Herzegovina is not yet ensured as the country fails to provide comprehensive state aid inventory consolidated at the country level. *Overall*, state aid remained high and the state continued to influence the economy through state-owned monopolies.

Economic integration with the EU

Bosnia and Herzegovina remains an open economy, in spite of some slight decline of trade openness in 2012. Total trade (the sum of the volume of exports and imports of goods and services) fell to 84.9% of GDP in 2012, as compared with 87% in 2011. The EU continues to be the country's largest trading partner. Its share in total exports has decreased marginally to 59.8%, while the share in imports has grown to 47.3%. The shares of the other main trading partner -the CEFTA block- fell slightly to 28.7% of total exports and 22.2% of total imports. In 2012, the real effective exchange rate based on the country's 20 largest trading partners appreciated slightly by 0.4% indicating some marginal price competitiveness losses. The share of FDI stocks from the EU to total FDI remained broadly unchanged and stood at 44.1% in 2012. *Overall*, the already high level of trade integration with the EU increased further.

7.3. CONLUSIONS

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

The economy contracted by 1.1% in 2012. However, indicators for the first half of 2013 show some signs of recovery. Unemployment is still very high. The quality of public finances remained low, even though public finance management was somewhat strengthened. Despite some slight improvement, consensus on economic and fiscal policy essentials remains weak, thus impeding reforms at the country level. The large and inefficient public sector with multiple overlapping competences on state, entity and municipal or cantonal level (especially in the Federation) continues to impose risk for fiscal sustainability. An inefficient legal and judicial system hampers enforcement capacity and is a clear deterrent for investment and a source of corruption.

The composition and the low efficiency of public spending in Bosnia and Herzegovina remain a concern. In this context, fiscal reporting needs to be further improved in order to increase the quality of analysis and policy design. Structural rigidities such as the excessive labour taxation and poorly targeted social transfers would require measures to spur labour demand. Authorities in the Federation should proceed with development of the pension reform. Given the high share of public companies in the economy, the authorities should reinvigorate privatisation, which has the potential to improve the fiscal situation and bring about more competition. The private sector needs to be supported by a sound business environment, most notably by improving contract enforcement and establishing a single economic space in the country. The informal sector remains an important challenge.

8. KOSOVO*

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

8.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Kosovo has further developed its relations with international financial institutions. It has continued to successfully implement the 20-month €105 million Stand-By Arrangement (SBA), negotiated with the International Monetary Fund (IMF) in April 2012. In December 2012, Kosovo became a member of the European Bank for Reconstruction and Development. In June 2013, Kosovo signed a Framework Agreement with the European Investment Bank (EIB), which allows the EIB to finance projects in Kosovo. The Fiscal Surveillance Mechanism with the European Commission has continued with meetings held twice a year. Kosovo has also launched preparations for an Economic and Fiscal Programme, which is the standard economic surveillance procedure for potential candidates. In early May, the government of Kosovo adopted its medium-term expenditure framework, covering the years 2014-2016. *Overall*, the determination to pursue market-oriented economic policies has been maintained and reforms accelerated in certain areas.

Macroeconomic stability

Kosovo's economy has been less shielded from the adverse effects of the economic crisis in Europe than in past years, with signs of an economic slowdown. The general economic situation remains challenging with very high unemployment. GDP growth came down from 4.4% in 2011 to 2.5% in 2012 and is likely to have remained subdued in the first half of 2013 as well. More prudent fiscal policy and rapidly decelerating credit growth have curbed domestic demand, supressing the investment activity in particular. Remittances, a major driver of private consumption, started recovering only in the second half of 2012. The weak economic prospects in a number of countries with significant Kosovo diaspora increase uncertainty. Economic statistics, national accounts in particular, remained extremely weak, hampering a comprehensive assessment of the economic situation. GDP per capita([1]) has reached €2 721 in 2012, equal to 11% of the EU-27 average, almost unchanged over its level in 2011. *Overall*, Kosovo's economic growth has weakened and remains fragile.

In 2012, the current account deficit (including official transfers) shrank to 7.7% of GDP, down from 13.8% of GDP in 2011. Higher current transfers and lower imports of goods and services helped reduce external imbalances. On the other hand, the performance of exports of goods deteriorated (down by 1.0% of GDP), as external demand and prices for metals and metal products, Kosovo's main exports, declined. As a result, trade imbalances remained significant, with a trade deficit of 35.1% of GDP, reflecting an underdeveloped and narrow domestic production base.

The surplus on the capital and financial account (excluding changes in reserve assets) stood at 13.2% of GDP in 2012. Net foreign direct investments declined to their lowest level since 2005 to 4.3% of GDP. The structure of investments remained broadly unchanged, with about half of all incoming foreign direct investment (FDI) going to the real estate and construction sectors, 12% to financial services, and only 13% channelled to manufacturing. The deficit in portfolio investments widened to

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

([1]) A measure using PPS is not available for Kosovo.

3.8% of GDP, but strong inflows of other investments, mostly currency and deposits, boosted reserve assets, which increased by 5.4% of GDP. Net errors and omissions remained very high (4.8% of GDP), close to their level in previous years. *Overall*, external imbalances have declined, although they are still very high, especially in merchandise trade. Net inflows from foreign direct investment fell markedly and continued to be channelled mainly in non-tradable sectors.

Unemployment is very high at 35.1%, according to Labour Force Survey (January to June 2012), which, due to methodological changes, does not allow for comparisons with previous years. The unemployment registry was digitalised and launched in early 2012. The number of people officially registered as unemployed decreased by about 22%. However, the sharp reduction mainly reflects changes in the registration system, rather than an improvement in the labour market situation. Most of the unemployed are unskilled (60%) and the number of unemployed with a university education has steadily increased. Structure of the labour market signals a mismatch between the skills needed on the labour market and those provided by the education system. Formal employment in the private sector increased slightly according to data on the number of contributors to the Kosovo Pension and Savings Trust Fund. The available statistics 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 patchy. Unemployment has remained very high, with significant structural weaknesses and skill gaps in the labour market. There are few job opportunities, especially for new young entrants.

The annual average rate of inflation was 2.5% in 2012. After having been elevated for several months in the second half of 2012, year-on-year inflation fell to 1.2% in August 2013. This moderation was mainly driven by the base effect and lower food and energy prices. Energy goods had a deflationary impact for the first time in last three years. Services inflation also came down markedly. Core inflation (non-food, non-energy) has been stable, close to 1%, gravitating around its long-term average. *Overall*, inflation has declined and continued to be driven mainly by food and energy prices.

Kosovo is using the euro as its legal tender. Consequently, the Central Bank of Kosovo (CBK) has only limited policy instruments. The growth in broad money supply has declined markedly and stood at 4.6% year-on-year by the end of July 2013, as compared to 9% a year ago. However, the monetisation of the economy, measured by the ratio of average broad money to GDP, increased from 40.7% in 2011 to 43% in 2012. The framework for providing emergency liquidity assistance became operational and the authorities funded a special reserve fund with €46 million. *Overall*, the monetary framework has continued to function relatively well.

Table 8.1:
Kosovo - Main economic trends

		2008	2009	2010	2011	2012	2013 H1
Gross domestic product	Ann. % ch	7,2	3,5	3,2	4,4	2,5	N.A.
Private consumption	Ann. % ch	8,6	2,1	3,1	3,0	2,8	N.A.
Investment	Ann. % ch	15,3	10,7	12,3	11,3	-10,9	N.A.
Unemployment	%	47,5	45,4	N.A.	44,8	35,1	N.A.
Employment	Ann. % ch	-12,9	8,7	N.A.	N.A.	44,7	N.A.
Wages	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Current account balance	% of GDP	-11,7	-9,3	-12,0	-13,8	-7,7	-7,7
Direct investment (FDI, net)	% of GDP	8,7	7,0	7,7	7,9	4,3	5,4
CPI	Ann. % ch	9,4	-2,4	3,5	7,3	2,5	3,0
Interest rate (3 months)	% p.a.	16,61	14,11	18,24	18,13	16,30	15,61
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	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-0,1	-0,7	-2,6	-1,7	-2,6	-2,6
General government debt	% of GDP	N.A.	7,7	7,6	6,7	8,3	8,6

Sources: Thomson Reuters/Ecowin, Eurostat, Local authorities

The 2012 budget deficit turned out close to target at 2.6% of GDP. Total revenue grew by only 1.8% and decreased to 26.9% of GDP from 27.3% in 2011. As economic activity cooled down, border taxes and non-tax revenue underperformed, while savings in spending on goods and services at central level and in non-highway capital expenditure compensated for lower revenues both at central and municipal level. Nevertheless, total expenditure increased by 5.3% for the year or by 0.7 percentage points, to 29.6% of GDP. Current expenditure reached 18.1% of GDP, up from 17.4% in 2011, driven by increases in all major categories. Capital expenditure and net lending decreased slightly by 0.2 percentage points, to 11.2% of GDP and more than 40% of these were spent on a single project, the highway to Albania. Government deposits available at the central bank increased from €160 million (3.4% of GDP) in 2011 to €216 million (4.4% of GDP) at the end of 2012. In 2012, the authorities started issuing domestic treasury bills with 3- and 6-month maturity, extended to one year maturity in April 2013. Supported by excess bank liquidity and stringent budgetary execution, yields have steadily declined and fluctuated around 0.5% and 1.5% for 3-month and 6-month bills respectively, in the third quarter of 2013. Total government debt increased by €156 million, but remained low at 8.3% of GDP by end-2012, of which close to a fifth was domestic debt. Budget transparency improved further and the Ministry of Finance started publishing quarterly information on government debt level and structure on its website.

In December 2012, the Assembly adopted the 2013 budget, envisaging a €181 million (3.5% of GDP) consolidated deficit. The budget contains fiscal adjustment measures, mostly in raising additional non-tax revenue from lignite royalties and one-off sale of telecoms licences. To guard against unforeseen fiscal risks, the budget also includes a contingency reserve of €20 million in unallocated spending commitments. An allocation of about 0.5% of GDP is envisaged for launching another big, multiannual road transportation project, a highway linking Pristina with Skopje. The 2013 budget performance was broadly on track by the end of July. The consolidated deficit was €6.6 million, which is significantly lower than the corresponding period last year. Revenue growth was boosted by the base effects and domestic tax revenues. By the end of July, year-on-year increase in total expenditure was 1.3%. Even though the current expenditures, subsidies and transfers increased significantly (by 1.6% of GDP), reduced non-highway capital spending kept the total expenditure at a modest level.

In April, the winning bidder for the privatisation of 75% of the state-owned telecom PTK was selected. However, the privatisation process has experienced delays, with the ultimate completion remaining uncertain. On the other hand, a number of initiatives with potentially significant impact on budget sustainability are being prepared in healthcare, municipal finance, and benefits to war veterans and political prisoners. In that regard, PTK is a key deal expected to bring €277 million to the budget.

In July, with amendments to the law on public finance management and accountability, the parliament introduced a legally-binding fiscal rule to be implemented as of 2014. The rule envisages a 2% of GDP ceiling on the general government deficit. *Overall*, budget performance remained broadly on track, in a challenging economic and social environment, but further efforts are needed to limit budget exposure to a number of new expenditure initiatives.

In 2012, growth and domestic demand weakened, as some of the major factors that had previously supported it, fiscal expansion, strong remittances and buoyant credit growth, were curtailed or decelerated. In the framework of an IMF-supported programme, significant steps have been taken to rein in government spending and improve financial stability. However, significant domestic and external imbalances persist. Structural weaknesses and skills gaps in the labour market remain significant and there are few job opportunities, especially for young entrants, aggravating an already difficult social situation. *Overall*, Kosovo managed to broadly maintain macroeconomic and fiscal stability, despite evident signs of weakening economic growth. Fiscal policy remained prudent and the macroeconomic policy mix has improved. Further significant efforts are needed to improve the structural characteristics of the economy.

Interplay of market forces

Out of 61 state-owned enterprises, 44 are managed by municipalities. Among those centrally managed, six enterprises had operating profits in 2012. This includes the Kosovo Energy Corporation and the Post and Telecommunications of Kosovo (PTK), which also paid €45 million in dividends to the budget. A few companies in the transport, water and waste sectors have continued to suffer losses. They have remained a significant drain on the budget, although to a lesser extent than in previous years. The Privatisation of the Kosovo Electricity Distribution and Supply Company (KEDS) was successfully completed when Turkish consortium Calik-Limak took over the company in May 2013. The privatisation of 75% of shares of the state-owned telecom PTK, initially envisaged to be concluded by July, is delayed. The Privatisation Agency of Kosovo (PAK) has continued privatising mainly small businesses. Total proceeds from the beginning of the privatisation process reached €574.4 million, with 2012 proceeds contributing €16.7 million. Limited progress has been made in liquidating enterprises from PAK's portfolio. In 2012, only two liquidation proceedings were closed and 179 firms remain in the process of liquidation. Proceeds from asset sales of enterprises in liquidation reached €62.7 million, of which €11.3 million were collected in 2012. *Overall*, the privatisation of state-owned enterprises has progressed, although unevenly, while the privatisation and liquidation of enterprises from PAK's portfolio lagged behind.

Market entry and exit

During 2012, 2 261 new businesses were registered, a rise of over 20% compared to the previous year. On the other hand, 334 businesses closed, or 16.7% more than in 2011. Businesses consider the lack of access to finance, power cuts, unfair competition (among local enterprises) and corruption as the main obstacles to doing business. *Overall*, weak administration, unreliable electricity supply and deficient rule of law have continued to hinder private sector development even though some progress has been made with regard to market entry.

Legal system

The legal system has continued to suffer from poor accessibility and efficiency, delays and a backlog of unresolved cases. Weak enforceability of contracts has 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. It has contributed to the rise in non-performing loans. There has been some progress regarding the property rights infrastructure, although the accuracy of data could be further improved. While expropriation procedures are applied in a broadly satisfactory manner and property owners are mostly compensated, the authorities do not carry out proper consultation and notification of displaced owners. Registered transactions and mortgages have continued to rise, indicating increasing use of property as collateral and acceptance by banks of cadastral records data for loan purposes. In 2012, the overall value of mortgages increased by 49%, reaching €1.3 billion. Some land registry books remain in Serbia. An agreement on cadastral records was reached within the framework of the Belgrade-Pristina dialogue. Appropriate legislation still needs to be passed to implement the agreement. *Overall*, there has been an increasing use of property as collateral. The existing legal framework is underdeveloped and its implementation has remained poor. Difficult, lengthy and costly legal enforcement and prevalent corruption has continued to hamper the business environment.

Financial sector development

In 2012, Kosovo's financial sector expanded by 8.5% with assets worth €3.8 billion. The banking sector remained predominant and accounted for 74% of all financial sector assets, followed by pension funds (19.5%). The total number of banks operating in Kosovo rose to nine in 2012, as a new bank entered the market. The number of pension funds (2) and insurance companies (13) has remained

unchanged. Concentration of the banking system remains high, with 70% of assets managed by the three largest banks. Almost 90% of the assets in the sector are held by banks under foreign ownership. Profits in the banking sector reached €19.2 million in 2012, a significant (46.7%) decrease compared to 2011. The proportion of non-performing loans rose to 7.6% of total loans on June, from 5.8% at the end of 2011. This is due to the deterioration in credit quality in the trade, real estate and construction sectors. Nonetheless, non-performing loans remain adequately provisioned and banks continue to hold considerable excess liquidity.

More stringent regulatory requirements as regards capital, which took effect in the autumn 2012, have put some of the banks' soundness indicators under pressure. Some banks fell below the regulatory minimum of 12% and had to be recapitalised. However, the average capital adequacy ratio stood at 16% at the end of July 2013. Amendments to the deposit insurance law, adopted in December, envisage an increase of the threshold for insured deposits from the current €2 000 to €5 000 by 2018. The capital of the Deposit Insurance Fund has been strengthened and a resolution was adopted to increase its reserve fund to 8-9% of all insured deposits over a period of 14 years.

In April 2013, the Constitutional Court issued a ruling that declared a number of articles of the 2012 law on banks, microfinance institutions and non-bank financial institutions incompatible with the Constitution. The articles in question refer to the possibility for NGO microfinance institutions to become joint stock companies. *Overall*, there have been important steps to strengthen financial stability and supervision, although there is significant scope for further improvements. Non-performing loans increased and banks' capital adequacy and profitability indicators worsened, although the system as whole has remained rather stable.

Credit activity decelerated strongly, from double-digit growth levels to around 4% by the end of 2012. However, the share of total loans and lease financing in GDP increased marginally to 36.3%. Since the beginning of 2013, commercial banks have extended €87 million in new loans, 4% less than in the corresponding period the previous year. The decline has been particularly pronounced in new investment loans for non-financial corporations, which have dropped by 29%, while consumer and mortgage loans increased strongly, by 45% and 17%, respectively.

A survey conducted by the central bank showed that banks applied stricter criteria for loans, mostly due to a negative perception of the overall economic situation. Loans to the trade sector continued to dominate the loan portfolio, accounting for 36% of it by the end of June 2013. Lending continued to be domestically financed; the loans-to-deposits ratio fell to 77.5%, limiting the risks of crisis spill-over through cross-border financing.

In 2012, deposits increased by 8.3%, amounting to €2.3 billion or 46.4% of GDP by the end of the year. By the end of July, growth in deposits decelerated and remained at 4.6%. The already good liquidity position of the banking system has improved further and commercial banks increased their holdings at the central bank to about €300 million. The average interest rate spread between loans and deposits declined slightly, but remained at a high 9.85% in 2012. In early 2013, banks' interest income growth turned negative for the first time ever, while interest expenditure and provisions have continued growing, reducing banks' profitability. *Overall*, the deposit base has continued to increase at a robust rate, while lending activity has decelerated and lending conditions have remained tight.

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

Existence of a functioning market economy

Macroeconomic stability has been largely preserved, against the backdrop of the economic crisis in

Europe and persistently high domestic and external imbalances. In a difficult environment, some steps have been taken to strengthen the financial system's framework, improve the business environment and limit budget expenditure. At the same time, significant further efforts are needed to develop a competitive private sector and to anchor fiscal sustainability. *Overall*, the weak rule of law, a large informal economy and an underdeveloped policy framework have continued to hamper the economy.

Human and physical capital

Some progress has been made in the education sector, especially as regards the systems and procedures for implementing a sector-wide approach to education. In line with the vocational professional education framework, new vocational training centres have been opened, curricula have been reviewed and a standardised certificate of accreditation has been developed for several vocational occupations. Education has remained one of the largest government programmes, accounting for about 4% of GDP. However, the resources allocated to it still remain relatively low. The modernisation of the public employment service has continued and the Employment Management Information System is operational, maintaining a database of jobseekers. *Overall*, there has been some progress in the education sector. However, it is still affected by the lack of adequate facilities, maintenance and quality assurance. It is characterised by poor results which do not sufficiently meet the requirements of the labour market. Significant investment in human capital is necessary to support Kosovo's socio-economic development.

Total investment is estimated to have declined in 2012. Nevertheless, it stood at a relatively high level of around 31% of GDP. Government investments (predominantly in road infrastructure) have slightly increased and remained high at 11% of GDP, while there appears to have been a slump in private investment. There has been little involvement of the private sector in key areas such as water and wastewater, road and railway services. The construction of the highway (R7) towards Tirana has continued and is scheduled for completion in 2013. Work on a new highway to Skopje is due to start towards the end of 2013, with an allocation of €28 million (0.5% of GDP), provided the revenue of the sale of PTK is available. In the area of energy infrastructure, The Calik Limak consortium took over the Kosovo Electricity Distribution and Supply Company (KEDS) in May 2013 and has committed €300 million to modernise and operate the distribution network. Little has been done to improve energy efficiency. Information about the level and structure of private investment has remained scarce. *Overall*, besides road infrastructure, there were marginal improvements in physical capital. Government capital spending remained focused mostly on highway construction, at the expense of other sectors' needs.

Sectoral and enterprise structure

Kosovo's enterprise sector remains dominated by small and micro-enterprises. Retail trade continues to be the dominant sector, with a share of 31.3% of all new enterprises, marking a small decline in the overall share in comparison to past years. There is a large informal sector 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. Access to finance and its cost have remained a challenge. In 2013, the government joined an EU-financed project which supports export-oriented micro enterprises and SMEs. The project's objective is to improve their technology and increase production capacity. *Overall*, the retail trade sector became slightly less dominant in the overall enterprise structure, largely because of the growth in newly-registered enterprises in agriculture. The large informal sector continues to pose a major challenge.

State influence on competitiveness

Budget subsidies and capital transfers to publicly-owned enterprises (POEs) declined slightly, to about 1.1% of GDP in 2012. Subsidies were granted to POEs in energy, railways, district heating, water and

waste, and the Trepča Mines. The government has continued with the grant scheme consisting of coupled payments to cereal and livestock farmers and matching grants for the dairy, fruit and vegetables sectors at farm level. In 2013, the government extended the coupled payment to other sectors (e.g. maize, sunflower and horticulture) and extended matching grants to forestry, irrigation schemes, aromatic plants and support to less favoured areas. Within the energy sector, the energy regulator (ERO) approved an increase in electricity prices of 8.9% in 2012 and refused further increases in 2013. *Overall*, state interference in the economy has declined, but remains high. The institutional framework to monitor and approve state aid has still not been established.

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, has remained stable around 71.2%. The share of exports to EU Member States decreased in comparison to 2011. It accounted for almost 39.6% of total exports of goods (43% in 2011). The share of exports to Central European Free Trade Agreement (CEFTA) countries increased significantly to approximately 37.8% of total exports (26% in 2011), especially on account of increased exports to Albania and Montenegro. EU and CEFTA countries have remained the main origin of Kosovo's imports, with shares of about 39% and 34% respectively. With about one third of overall investments, EU countries remain the biggest investors in Kosovo. *Overall*, economic integration with the EU remains significant.

8.3. CONCLUSIONS

As regards the economic criteria, Kosovo has made some 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.

The challenging economic situation in the region and the EU has started to affect Kosovo's economy, although less than in other countries of the region. Kosovo's GDP grew by 2.5% in 2012. Fiscal policy has been prudent and budget performance has been on track. A legally binding fiscal rule was introduced, to be implemented in 2014. Unemployment has remained very high. Kosovo has continued significant investments in its infrastructure.

Continuous efforts are needed to support macroeconomic stability and improvement in the social situation. Kosovo needs to improve its competitiveness and business environment, and support the private sector so as to reduce unemployment. A sound business environment demands further measures to tackle the weak rule of law and corruption. Privatisation needs to continue. The informal sector remains an important challenge.

ANNEX 1

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
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

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