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Progress towards meeting the economic criteria for EU accession: the EU Commission's 2014 assessments

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European Commission
Directorate-General for Economic and Financial Affairs

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* This designation is without prejudice to positions on status, and is in line with UNSCR 1244 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 2014 European Commission's progress reports for candidate countries and potential candidates for EU accession. The Commission prepared these reports for the five candidate countries: the former Yugoslav Republic of Macedonia, Albania, Montenegro, Serbia and Turkey as well as for the two potential candidates: Bosnia and Herzegovina and Kosovo. ([1]) The reports assess progress achieved over the last 12 months in each of the countries with a view to advance necessary political and economic reforms as well as legal transformation in line with the EU criteria. The European Commission adopted the progress reports on 8 October 2014 as part of its 2014 Enlargement Strategy.

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 2014 Progress reports, i.e. the Commission staff working documents for each of the countries.

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]) Iceland is a candidate country, but its government in May 2013 decided to put EU accession negotiations on hold and to cease its contributions to the annual progress reports. Therefore, Iceland is not covered by the 2014 vintage of the reports.

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 2014 assessments

1. ALBANIA

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

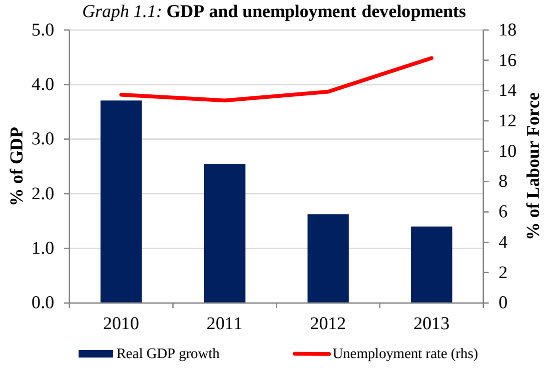
Albania maintained macroeconomic stability but still faces significant challenges. Persistent fiscal imbalances have caused public debt to reach high levels and fiscal buffers are largely exhausted. Large accumulated government arrears have sapped liquidity and confidence in the economy, despite the government beginning to clear these in March. The high current account deficit reflects weak competitiveness and a narrow production base. The private sector is held back by weaknesses in the regulatory environment and the rule of law. Substantial efforts are required to improve the labour market.

Economic policy

Macroeconomic stability was broadly preserved, but vulnerabilities remain elevated mainly as a result of fiscal and, to a lesser extent, external imbalances. In January, Albania submitted its eighth Economic and Fiscal Programme, covering 2014-16. The programme's medium-term macroeconomic scenario assumes a reacceleration of growth coupled with fiscal consolidation; such an outlook faces challenges and requires sustained effort to be achieved. The conclusion in February and May 2014 of loan agreements with the IMF and the World Bank respectively is expected to provide an anchor for increasing macroeconomic stability and implementing growth-boosting reforms. A National Economic Council, chaired by the Prime Minister and involving the business community, was set up in the last quarter of 2013 to provide guidance and consistency in economic reforms. ***Overall, the consensus on the main fundamentals of economic policies has been maintained.***

Macroeconomic stability

Graph 1.1: **GDP and unemployment developments**



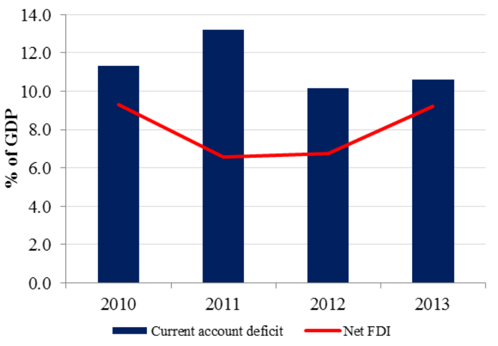
GDP growth decelerated further to an estimated 1.4 % in 2013 from 1.6 % a year earlier. The main driver of the slowdown remained sluggish domestic demand, as both private consumption and especially investment were adversely affected by weak confidence and anaemic lending. Uncertainty, partly related to the high level of unpaid government obligations towards businesses, was slow to dissipate, even if the repayment of arrears started in March. Net exports maintained their positive contribution in 2013 as a result of stagnating imports and good export performance. In the first quarter of 2014, GDP growth was still low at 1.7 %, but survey indicators point to a broader-based recovery of private domestic demand in the second quarter. Per capita GDP in purchasing power standards remained at 30 % of the EU-28 average in 2013. ***Overall, the timely execution of the plan to clear accumulated government arrears and the removal of obstacles to bank lending are key to further improving confidence, bolstering investment and reviving growth in the short run.***

Table 1.1:
Albania - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	3.4	3.7	2.5	1.6	1.4	0.6
Private consumption	Ann. % ch	0.7	1.7	1.8	0.7	N.A.	N.A.
Gross fixed capital formation	Ann. % ch	1.0	-8.5	5.9	-11.3	N.A.	N.A.
Unemployment rate	%	13.8	14.2	14.3	13.9	16.1	18.0
Employment	Ann. % ch	0.4	-0.1	2.3	3.6	-0.3	-5.6
Wages, public sector	Ann. % ch	11.9	6.7	7.0	7.3	4.1	1.9
Current account balance**	% of GDP	-15.4	-11.3	-13.2	-10.2	-10.6	-12.3
Direct investment (FDI, net)**	% of GDP	7.7	8.8	6.6	6.7	9.5	6.6
CPI, average	Ann. % ch	2.3	3.6	3.5	2.0	1.9	1.8
Exchange rate LEK/EUR	Value	132.06	137.79	140.33	139.04	140.26	140.22
General government balance	% of GDP	-7.0	-3.1	-3.5	-3.4	-4.9	-1.6
General government debt	% of GDP	59.7	57.7	59.4	62.0	65.2	64.7

** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

Graph 1.2: **Balance of Payments developments**



External imbalances remained large, reflecting a narrow production base, the overall low competitiveness of the economy and a large fiscal deficit. The current account deficit increased slightly to 10.6 % of GDP in 2013. Strong growth in exports of goods, driven by crude oil sales and electricity exports thanks to favourable hydrological conditions, and a slight decrease in goods imports helped the substantial trade deficit to narrow, but the traditional surplus on the services account practically disappeared due to weak tourism sector performance. The current transfer surplus also declined substantially due to a 26 % drop in remittances from migrant workers in 2013. In the first quarter of 2014, the current account deficit widened by 31 % year-on-year as strong growth of goods exports was offset by a pick-up in imports, reflecting stronger consumption and private investment. The services account deficit also widened despite inbound tourism showing signs of improvement, as tourism outflows also increased. In the same period, the decline in remittances slowed down but did not reverse.

Risks resulting from a large current account deficit continued to be mitigated on the financing side by a healthy reliance on foreign direct investments (FDI) as opposed to debt-generating flows. Net FDI inflows, driven by investments in extraction and privatisations in the hydropower sector, surged by 38 % in 2013 to 9.2 % of GDP and covered the bulk of the current account shortfall. Official reserves increased in 2013 and at year-end covered 4.7 months of imports; the import coverage was at around the same level at end-June 2014, providing an adequate level of safeguard against adverse shocks. Net FDI inflows increased by 11.7 % year-on-year and continued to be substantial in the first quarter of 2014. ***Overall, continued strong emphasis on attracting foreign direct investment is crucial both for mitigating vulnerabilities linked to high external imbalances and for transferring knowledge, boosting productivity and broadening the production base***.

Labour force survey data suffer from shortcomings but indicate continued deterioration in labour market conditions. The average rate of unemployment increased in 2013 by 2.2 percentage points to 15.6 % and remained on an upward trend throughout the year, reaching 18.3 % in the first quarter of 2014. While some aspects of the labour market, such as the ease of hiring and firing or the link between pay setting and productivity, display sufficient flexibility, the high prevalence of long-term unemployment and large gender differences in labour force participation indicate significant structural impediments. The activity rate of the population aged 20-64 is comparably low at 68 %, as is the employment rate, which stood at 57.2 % in 2013. Informal employment remains widespread, hindering company development and fiscal revenues, reducing job security and affecting social security entitlements. ***Overall, Albania needs to continue its work to address the high unemployment rate and the high prevalence of informal employment.***

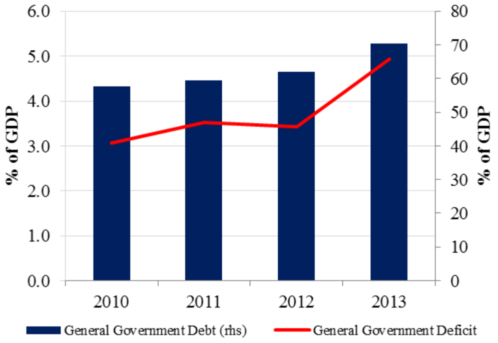
Macroeconomic stability continued to be supported by a sound monetary policy operating under an inflation-targeting regime. Weak aggregate demand and low imported inflation led the average inflation rate to decelerate to 1.9 % in 2013, slightly below the lower band of the Bank of Albania's target range of 2-4 %, and it continued to hover around this level in the first half of 2014. Low inflationary pressures created room for further monetary policy easing, and the Bank of Albania cut the key interest rate several times, bringing it down to a new historic low of 2.5 %. However, the stimulus has only partly been passed on to the economy in the form of lower lending rates, due to banks' high risk aversion amid a large proportion of non-performing loans on their balance sheets. The free-floating exchange rate of the lek remained broadly stable against the euro in 2013 and the first eight months of 2014, helping to keep imported inflation low. The degree of euroisation of the financial system decreased somewhat but remains high, constraining monetary policy. Alleged theft at the Bank of Albania led to the prosecution and dismissal of a number of officials, including the governor who is accused of abuse of office. When addressing this issue, central bank independence should be safeguarded and the proper functioning of the institution should be ensured. ***Overall, low inflation allowed the monetary policy easing cycle to continue, but its impact on aggregate demand remained constrained by banks' high risk aversion***.

The budget deficit was at 4.8 % of GDP in 2013, exceeding the initial target of 3.5 %. Disappointing revenue from direct taxes and election-related spending increases in the first half of the year necessitated a substantial revision of the budget in October. In 2013 as a whole, total revenues were 8.9 % lower than initially planned. In terms of expenditure, efforts to contain the budget shortfall focused again on cutting capital spending, which ended up 7.8 % lower than planned, although it did increase marginally as a share of GDP (to 4.8 %).

The need to finance the budget deficit and the recognition of accumulated arrears, estimated at 5.3 % of GDP, pushed up the level of public debt to 70.5 % at the end of 2013, from 62.3 % a year earlier. Even though efforts to lengthen the maturity profile of the debt stock achieved some results in 2013 (notably with the first successful issuing of a 10-year bond), its short-term component remains high, exposing the country to refinancing risks. The narrow investor base, which comprises mainly domestic banks, adds to these vulnerabilities and also exposes local banks to sovereign risk.

The government adopted an arrears clearance and prevention strategy in February. It aims, with the support of loans from the IMF and the World Bank, to clear arrears within three years and implement substantial improvement in public finance management to avoid their re-emergence. Unpaid bills and outstanding tax refunds were not previously captured by official debt statistics; recognising and settling them therefore constitutes a major step forward in terms of increasing transparency and re-establishing trust in the government as a contract partner. In March, the government began the process of clearing outstanding arrears, clearing roughly 35 % of total arrears by end-July. An independent external auditor

Graph 1.3: **Fiscal developments**



has been contracted to enhance the reporting framework and ensure proper oversight of the process.

The stated objective of fiscal policy in 2014 is to consolidate public finances while clearing a large part of government arrears. This translates into a deficit target of 6.5 % of GDP, which includes repayment of arrears worth 2.5 % of GDP. Increases in excise, fuel and building taxes, as well as an increase in corporate income tax from 10 % to 15 % are expected to underpin the forecast 11 % rise in overall revenue, while the introduction of progressivity in personal income tax is projected to have a slightly negative budgetary impact. Changes implemented by the new government to the tax and customs administrations caused disruption, but measures were taken to address fiscal evasion, uncovering several VAT and excise fraud schemes, and to improve tax collection. As a clear sign of progress, revenues in the first seven months of 2014 were up by 11 % in annual terms, driven by a 16.5 % surge in VAT receipts *(See also Chapter 16 — Taxation)*. Due to an underspend on investment caused by a reassessment of existing projects and procedures, total expenditure was at the same level as a year earlier, despite beginning arrears repayments. The overall deficit in the first seven months was 38 % lower than a year earlier and amounted to around 2.2 % of the full-year GDP.

Fiscal consolidation is expected to continue after 2014, although this could require additional policy measures in the next two years. Significant fiscal risks stem from an unreformed energy sector where the government acts as financer of last resort and from the obligation for the state, confirmed by recent judgments of the European Court of Human Rights, to pay compensation to former property owners, unless the modalities for compensation are adjusted. The public debt to GDP ratio is forecast to decrease from 2015. With basic legislation amended in July, progress was made on reforming the pension system with a view to improving its sustainability in the long run and decreasing the long-term implicit liabilities of the state.

Overall, macroeconomic stability should be further increased by lowering the public debt-to-GDP ratio, while preserving fiscal space for growth-enhancing public investment. Fiscal consolidation, focusing on revenues, started with the 2014 budget, but continued work is needed to put public finances on a sustainable footing. The ongoing clearance of arrears and the improvements in public finance management constitute major steps forward and should be carried out as planned.

Interplay of market forces

The private sector remains dominant, accounting for about 80 % of GDP and 82 % of the workforce. Privatisation is advanced but there was no progress on the sale of the remaining stakes in energy, oil, telecommunications and insurance companies. The dispute following the earlier revocation of the privatised electricity distributor CEZ Shpërndarje’s licence was resolved in June, with a deal in which CEZ receives € 95 million as payment of receivables and for the transfer of shares. Efforts to increase private sector involvement in the energy sector resulted in the signature of 14 new concessions for electricity generation during 2013. The proportion of total electricity generation provided by private hydro power plants increased to 11 % in 2013, from an estimated 7 % in 2012. However, high distribution losses, accumulated arrears, regulated tariffs below cost-recovery level and a lack of market-based mechanisms are detrimental to investor interest in the sector and should be resolutely addressed, also in order to lower fiscal risks. *(See also Chapter 15 — Energy).* ***Overall, state involvement in the economy remains limited and is mainly concentrated in some sectors, such as energy which needs wide-ranging reform.***

Market entry and exit

Market entry is adversely affected by bureaucratic procedures and weaknesses in the regulatory environment. Although the time it takes to start a new business is relatively short, the associated costs can be high. In 2013, the number of registered new businesses declined slightly by 1 %, following strong growth the year before. Bankruptcy procedures remain slow, while the recovery rate for debtors in most cases turns out to be low. As a result, the bankruptcy regime does not appropriately support efficient debt resolution. Under the bankruptcy regime, eight applications for restructuring were registered in the first half of 2014, compared with just four in the whole period 2008-2012 and one in 2013. The number of new liquidation cases also increased in the first half of 2014. Preparations for the revision of the bankruptcy law have started. ***Overall, both market entry and exit procedures should be further improved to facilitate an efficient allocation of resources.***

Legal system

The pace of property legalisation, restitution and compensation remains slow. The first registration of properties has yet to be completed in 470 land registry zones, of which 399 are rural. Parliament decided in December to postpone the deadline for processing the verification of titles concerning agricultural land until the end of 2015.

There was some progress on setting up administrative courts, which became operational in November. In March, the Ministry of Justice adopted guidelines on the fees to be paid to private bailiffs, allowing negotiation of payments upon successful completion of the collateral execution process, instead of a full upfront payment. This is expected to align incentives with creditors for a prompt execution of collateral. The Economy Ministry is conducting a survey of wrong and harmful procedures with a view to addressing regulatory weaknesses, while a cross-institutional working group has been set up to consider any necessary legal and procedural changes to improve the business environment. ***Overall, progress is needed on reforms to deal with uncertainties over property ownership, deficiencies in the regulatory framework and weaknesses in contract enforcement and the rule of law, which continue to be detrimental to the business environment***.

Financial sector development

The predominantly foreign-owned banking sector continued to dominate the financial system, accounting for 90.8 % of all financial system assets. Sluggish credit demand and banks' increased risk aversion caused the stock of outstanding loans to decrease by 2.1 % in 2013, with business loans contracting the most. Despite continued monetary policy stimulus, the downward trend in lending continued in the first half of 2014, but in July the stock of loans increased in annual terms for the first time in twelve months, albeit at a slow pace (0.5 %). Overall credit to the economy fell to 40.6 % of GDP at end-March from 42.8 % a year earlier, suggesting that there is significant scope for deeper financial intermediation.

The share of non-performing loans has begun to level off after almost five years of steady increase, but it remains high (24.1 % in June 2014) and is the main source of concern in the banking sector. In February, the Bank of Albania's Supervisory Council adopted a requirement for banks to write off, from January 2015, non-performing loans no later than three years after they had been classified in the 'loss' category. It also strengthened credit underwriting practices and non-performing loan recovery and resolution for large borrowers. Banks are also exposed to credit risk stemming from the currency mismatch of borrowers with foreign currency loans but with domestic currency income. Such loans make up more than 30 % of the total stock and are particularly sensitive to large exchange rate depreciations.

Despite very high NPLs, lingering credit risks and exposure to sovereign risk through significant holdings of government securities, the banking sector appears stable. Capital and liquidity ratios largely exceed requirements and deposits continued to be the main source of funding for banks, which have very limited reliance on external sources and parent bank credit lines. Loan losses are well provisioned, which has weighed on banks' earnings. However, profitability indicators remain positive and have been improving since the fourth quarter of 2013.

The size of the non-banking financial sector has increased but remains small; its assets amount to 5.4 % of GDP, up from 2.8 % in 2012. It comprises the insurance and private pension segments, as well as investment funds. Their regulatory and supervisory framework requires further strengthening. ***Overall, the banking system is well capitalised and liquid. However, further measures are needed to address the issue of non-performing loans which hamper financial intermediation***.

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

Human and physical capital

Despite significant improvements over the last decade, Albania still has considerable gaps to close in terms of years of schooling, secondary enrolment rates, education quality and the market relevance of qualifications. Public spending on education is low at around 3 % of GDP, and is expected to stay at this level in 2014 as more spending allocations for primary and secondary education will be offset by cuts in higher education funding (mainly as regards capital expenditure). A draft national employment and skills strategy was unveiled in February; it will run until 2020 and aims to overhaul active labour market policies, improve vocational education and training, reform social safety nets and strengthen labour market governance.

Gross fixed capital formation as a share of GDP dropped again to around 26 % in 2012; the downward trend was expected to continue in 2013. Public capital expenditure, at 4.8 % of GDP in 2013, is often targeted by spending cuts when budget adjustments are needed. Public spending on research and development is set to increase by 4 % in 2014, but it continues to represent only 0.01 % of GDP. The foreign direct investment stock has reached € 4.5 billion, representing 46.5 % of Albania’s GDP in 2013.

The need for investment is evident in many areas, including the energy sector. An almost exclusive reliance on hydropower exposes Albania to large fluctuations in power generation, resulting in large electricity imports in low-rainfall years. Work to increase the capacity of transmission and interconnection networks achieved some results, notably a financial agreement for the construction of the Albania-Kosovo interconnection line. The imminent start of construction of the Trans-Adriatic Pipeline through Albanian territory may introduce gas to the energy mix in the longer term. Nevertheless, significant weaknesses in the electricity sector remain and need to be addressed. *(See also Chapter 15- Energy).* ***Overall, given the substantial need for investment in human and physical capital, it is necessary to rebuild fiscal space for growth-enhancing public expenditure, to improve education outcomes to meet labour market needs and to attract private investment, in particular foreign direct investment, by improving the overall investment environment.***

Sectoral and enterprise structure

The Albanian economy continues to be dominated by the services sector, which accounted for around 50 % of gross value added (GVA) in 2013, followed by agriculture, providing more than a fifth of GVA, and industry (15 %), comprising both manufacturing and the booming extractive industries (crude oil production increased by 18 % in 2013). Manufacturing relies to a large extent on the low value-added textile and footwear industries. Following a deep contraction a year earlier, the construction sector recorded modest growth. Agriculture continues to provide a very large proportion of employment (around 45 %), although this fell by almost 3 percentage points in 2013. The sectoral composition of merchandise exports remained highly concentrated, with 83 % of total exports in 2013 accounted for by mineral products (40 %), textiles and footwear (28 %) and construction materials and metals (15 %). This lack of diversification exposes the economy to industry-specific shocks.

Small and medium-sized enterprises (SMEs) play a very significant role in the economy, providing 80 % of employment and 68 % of value added. Micro-businesses in particular make up a high proportion of the number of companies and account for more than 50 % of all people employed by SMEs. Various state and donor-funded schemes exist to increase SMEs' competitiveness and help them access finance. ***Overall, agriculture continues to have a large role in the economy, suggesting that there is significant scope for productivity gains from sectoral shifts in employment. The sectoral composition of exports remains highly concentrated***.

State influence on competitiveness

Total state aid granted declined by 6 % in 2013 and amounted to 1.5 % of GDP. The share of less distortive horizontal (i.e. non-sector-specific) aid increased further to 89 %. Similarly to previous years, the government provided loan guarantees worth € 83 million or 0.8 % of GDP to the state-owned power company KESH to help it survive financial difficulties and enable it to import electricity in late 2013 and early 2014. The unresolved problems of the electricity sector are an enduring drain on public resources.

Economic integration with the EU

Albania's openness to trade, defined as the ratio of total imports and exports to GDP, increased slightly to 88 % in 2013. Imports exceeded exports by a margin of 18 % of GDP, but the trade deficit has shrunk for the last two years, despite a more than 2 % appreciation of the lek's real effective exchange rate since September 2013. Exports constituted 40.2 % of GDP in 2013, up from 33.3 % in 2012.

The EU remains by far Albania's largest trading partner. Exports of goods to the EU increased by 18 % in 2013 and accounted for some 84 % of total merchandise exports, while imports of goods from the EU made up 64 % of the total. Although in recent years Albania has managed to diversify somewhat its client base away from Italy (notably to Spain, Turkey and Kosovo), Italy remains its single largest trading partner, purchasing more than half of Albanian merchandise exports and providing a third of its goods imports. The EU also remains the main source of inward investment in Albania. Trade links with fellow Central European Free Trade Agreement (CEFTA) countries loosened in 2013 on account of a 16 % fall in merchandise imports from the bloc, partly reflecting weaker demand in Albania. CEFTA countries accounted for some 12 % of Albanian merchandise exports and 7 % of its imports of goods. ***Overall, Albania's openness to trade slightly increased. The EU remains its dominant trading partner, while trade links with CEFTA countries weakened***.

1.3. CONCLUSIONS

As regards the economic criteria, Albania made some 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 further accelerates structural reforms.

Albania preserved macroeconomic stability, proceeded with arrears clearance and took steps to improve tax administration and collection. However, economic growth slowed further and the current account deficit remains large, reflecting weak competitiveness. The budget deficit exceeded the target in 2013 and the high level of public debt increased further restricting the fiscal room for manoeuvre. Inflation remained low, which allowed monetary easing to continue, but this did not translate into credit growth due to the high level of non-performing loans in commercial banks. Unemployment is high and the informal economy remains widespread.

Albania should pursue fiscal consolidation efforts with a view to reducing public debt, while at the same time preserving room for growth-friendly expenditure. The energy sector should be reformed and pension and tax administration reforms to be further implemented in order to lower the risks it poses to public finances. Bank lending and credit growth need to be supported by the continued payment of state arrears towards companies and by addressing non-performing loans. Obstacles to private-sector development should be removed by mproving the business environment, which is characterised by deficiencies in the rule of law, weaknesses in the regulatory framework and uncertainty over property ownership. Creating favourable conditions for private investment, and in particular foreign direct investment, is essential for diversifying the narrow production base. Education and training should be further improved to address skills mismatches in the labour market and increase employability.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Driven by a strong external sector and foreign direct investment, the economic recovery progressed and external imbalances declined somewhat. Yet, structural rigidities continue to impede the proper functioning of the labour market, and fiscal discipline and transparency suffer from being driven by short-term, ad hoc concerns. While the involvement of the state in the economy remains moderate, in terms of its share in productive capital and its intervention in price setting, the development of a competitive private sector is hampered by difficult contract enforcement, frequent legal changes without adequate consultation of stakeholders, and uneven enforcement of regulatory compliance requirements. Implementation of reforms to improve the business environment remains sluggish. The development of the domestic economy depends on building better linkages between foreign investment companies and local businesses which, in turn, requires government and local businesses to work on better skills-matching and investment in higher-productivity activities. Improvements in market entry and exit would also help.

Economic policy

The government remains committed to growth and employment-enhancing policies focusing on foreign investment and the development of the domestic private sector. The labour market situation improved somewhat, but unemployment remains persistently high, in particular among the young. Fiscal discipline and transparency deteriorated further, affecting growth-enhancing capital spending. In January 2014, the authorities submitted the eighth Pre-accession Economic Programme (PEP), outlining key economic, fiscal and structural reforms for the period 2014-2016. Its macroeconomic and fiscal framework is somewhat optimistic with gradually increasing growth averaging close to 4 %, driven by domestic demand, and a gradual reduction in the general government deficit ratio to 2.6 % in 2016. The country would need to step up its efforts, in line with the Conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Candidate Countries from May 2014, in order to strengthen medium-term budget planning and execution and to improve the employability of workers. In line with the same Conclusions, further efforts will be needed to improve the business environment, in particular market exit procedures and access to finance. ***Overall, the political consensus on the fundamentals of a market economy was maintained, but economic policy and public expenditure management remain driven by ad hoc concerns rather than the long-term requirements of the economy***.

Macroeconomic stability

The economic recovery that began cautiously in the second half of 2012 has gained firmer ground. Driven by the external sector, output expanded by 2.9 % in real terms in 2013. Growth increased to 3.9 % year-on-year in the first half of 2014. Investment activity slowed down considerably in 2013, improving temporarily in the first quarter of 2014, before slowing thereafter. Private consumption contributed positively to GDP growth in 2013, and remained resilient in 2014. Industrial production has picked up significantly since the fourth quarter of 2013, mainly due to a strong recovery in manufacturing. GDP per capita remains at about 35 % of the EU average.

Graph 2.1: **GDP and unemployment developments**

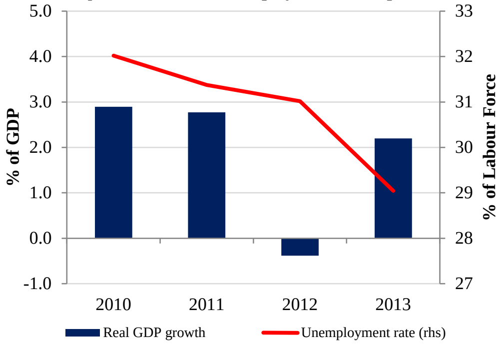


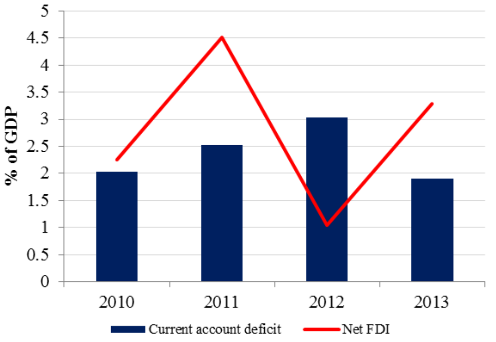
Table 2.1:
The former Yugoslav Republic of Macedonia - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	-1.0	2.8	3.0	-0.4	2.2	3.9
Private consumption	Ann. % ch	-4.9	1.5	2.9	-3.0	3.2	3.1
Gross fixed capital formation	Ann. % ch	-0.9	-4.3	15.7	21.2	-9.9	7.6
Unemployment rate	%	32.2	32.1	31.4	31.0	29.0	28.3
Employment	Ann. % ch	3.4	1.3	1.1	0.8	4.3	2.0
Wages	Ann. % ch	14.1	0.9	1.3	0.2	1.2	0.2
Current account balance**	% of GDP	-6.8	-2.0	-2.5	-3.0	-1.9	-1.7
Direct investment (FDI, net)**	% of GDP	2.0	2.2	4.6	1.5	3.5	3.6
CPI, average	Ann. % ch	-0.8	1.6	3.9	3.3	2.8	-0.2
Exchange rate MKD/EUR	Value	61.28	61.51	61.53	61.53	61.58	61.65
General government balance	% of GDP	-2.6	-2.4	-2.5	-4.2	-3.9	-2.7
General government debt	% of GDP	23.6	22.7	27.6	31.5	34.2	32.6

** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

The current account deficit narrowed in 2013 to 1.8 % of GDP, as the merchandise trade balance improved, and in spite of a drop in current transfers. In the same period, foreign direct investment (FDI) inflows strengthened– in 2013, they accounted for 3.5 % of GDP, and stayed at the same level in the first half of 2014. For the same period the current account deficit declined, by 1.7 % in annual terms, on the back of a renewed pick-up in transfers, and in spite of a widening deficit in foreign trade. Increased government borrowing abroad and a surge in foreign loans to public enterprises were the main forces behind the gradual increase of gross external debt. At the end of the first quarter of 2014, it stood at 66 % of projected GDP, and increased further since then, as a result of the government's € 500 million Eurobond issue in July. Looking ahead, as transfer inflows are expected to remain volatile, foreign investment and government external borrowing will have to carry the brunt of financing the current account deficit, which is likely to widen somewhat in the short term, given the substantial import needs arising from public infrastructure projects and the establishment of the new foreign entities. This is expected to be followed by a pick-up in export activity starting in 2015, when the new capacities are taking up operations. ***Overall, output growth needs to be more broadly based, and external imbalances are likely to widen again temporarily in view of investment-related imports.***

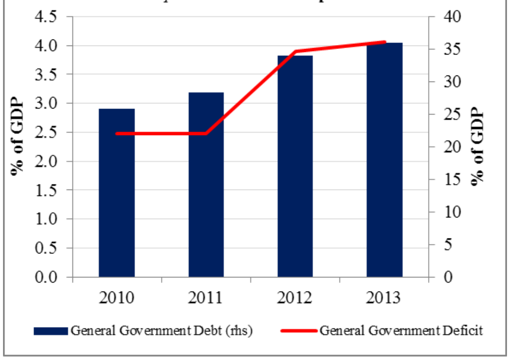
Graph 2.2: **Balance of Payments developments**



Labour market conditions improved marginally, but remained challenging. The unemployment rate fell gradually, to 28.2 % in the second quarter of 2014, from an average of 29 % in 2013. However, youth unemployment remains at over 50 %, and four out of five registered unemployed have been so for a year or more. In 2013 employment rate remained relatively low at 50.3 % while labour force participation rate was 70.4 %. While employment was 1.3 % higher in the second quarter of 2014 than a year earlier, a large share of the new jobs, as in previous years, was in low-productivity sectors in the informal economy and — spurred by public subsidies — in agriculture, as well as in the public sector, aided by a significant increase in active labour market measures. More recently, the employment impact of the new foreign entities became visible in a pick-up in manufacturing jobs. Although complete information on public sector employment has not been provided or published, it is estimated that its share of total employment remained at about 20 %. The labour market remains marked by structural rigidities such as low labour force participation, a lack of mobility of workers between sectors, a skills mismatch and slow reforms of the training and education system, subdued innovation activity by firms, and low labour productivity. ***Overall, reforms to tackle the structural rigidities of the labour market have made only limited progress. The employability of workers should be improved through structural measures as well as through better targeting of the active labour market measures.***

Monetary policy remained successful in defending the currency peg. The inflation environment remained benign, creating room for monetary policy to stimulate sluggish credit growth. The increase in the consumer price index (CPI) averaged 2.8 % in 2013, down by about 0.5 percentage points since 2012 and fell further in spring 2014, mainly due to declining prices for food and housing and utilities. Following a three-month long deflation, consumer prices rose again in July, as regulated electricity prices for households were raised and food prices stopped falling. After several cuts in the key monetary policy rates in January and July 2013, and an adjustment of reserve requirements to incentivise bank lending in local currency, the Central Bank reduced remuneration on banks' required reserve deposits to zero in November 2013, but loan and deposit rates declined only slowly.

Graph 2.3: **Fiscal developments**



Fiscal discipline and the quality of public spending deteriorated further in 2013 and 2014. In both years, the government was again forced to adopt a supplementary budget due to pressures arising from revenue shortfalls and repayment of accumulated arrears owed to private companies in the first half of the year. The 2013 central government deficit target was raised from 3.6 % to 3.9 % of GDP, accounting for a substantial increase in pension payments and for the arrears, while the actual deficit, at 4.1 %, exceeded even the revised target. With a budget rebalance the planned budget deficit for 2014 was raised from 3.5 % of GDP, to 3.9 %. Spending was heavily concentrated in the pre-electoral period, and by end-July about 85 % of the original deficit target had been reached. Furthermore, capital expenditure makes up a relatively small part of overall spending — it accounted for 12 % of total expenditure in the 2013 supplementary budget — and is prone to under-execution, with only four fifths of budgeted sums executed.

The government's medium-term strategy for 2014-2016 foresees a gradually declining general government deficit, to reach 2.6 % in 2016. However, the government's stated goal of current expenditure-based consolidation is not sustained by policy measures. Pensions and agricultural subsidies were raised in spring 2014, and increases in public wages are planned. Deficiencies in public financial management led to a marked decline in fiscal transparency and fiscal discipline in recent years. To address these shortcomings, government budget users have been required, since January 2014, to record multi-year liabilities and to respect multi-year expenditure ceilings. In July, the government proposed the introduction of constitutionally-anchored ceilings on the central government deficit and on public debt, but did not provide adequate implementation details ensuring a sound, rules-based application of these provisions. An amendment to the Law on financial discipline, dealing with late payments, extended the law's scope to the public sector, which could possibly alleviate the problems of government payment arrears to the private sector. However, the law contains a number of derogations and delayed entry into force for government entities, thus impeding its effectiveness. ***Overall, fiscal discipline needs to be improved, and there is significant scope for enhancing fiscal***

transparency. The government's fiscal consolidation plans need to be underpinned by concrete measures.

The general government debt ratio, still comparatively moderate, has been rising continuously since 2008, mainly on account of increasing primary budget deficits. Central government debt stood at 40.8 % of GDP at end-July 2014 — before the launch of the Eurobond — compared to 34.1 % at end-2012 and 20.6 % at end-2008. Debt accumulated by public enterprises, and related contingent government liabilities due to debt guarantees — estimated at some 8 % of GDP — are a particular concern, as the government has shifted a large share of its spending on road construction off-budget to a new public enterprise. Hence, total public debt stands at close to 50 % of GDP, and is likely to rise further in the short- to mid-term, given the considerable financing needs related to planned investment projects. ***Overall, the continued increase in the levels of government and public debt gives rise to concern about its long-term sustainability. The government needs to take steps to stabilise debt levels.***

Interplay of market forces

The economic importance of the public sector remained largely unchanged, with the private sector share in total assets of the economy at 85 %. While the overall number of enterprises with government participation decreased by 2, the number of enterprises in full state ownership remained unchanged, at 15, as did the level of capital in the five companies — mainly public utilities — with the largest share of state participation. In addition a Public Enterprise for State Roads started operations in January.

Administered and regulated prices account for some 13 % of the CPI basket. Regulated prices — about 12 % of the basket — usually cover production costs. Administered prices, such as for water and waste, account for only about 1 % of the basket and usually do not cover costs. ***Overall, the state's share in the economy's assets and in price setting remains moderate.***

Market entry and exit

The 'regulatory guillotine' project of the government has made some progress in facilitating market entry, focusing on the reduction of administrative burdens and on measures for small and medium enterprises. However, business still faces difficulties in obtaining licenses and permits — the 'one-stop shop' procedure is advancing only slowly, and needs to be extended to business activities beyond construction permits. Obstacles to setting up a private business are a particular concern, as they tend to hamper the establishment of (import substituting) supply chains between the more technologically advanced foreign entities, and the domestic private economy. Improvements in market exit procedures remain even more limited. The number of bankruptcy procedures and deletions from the trade registry decreased in 2013 — between September 2013 and May 2014 it was lower by over 40 % compared to a year earlier. Despite previous reforms to speed up proceedings, only 20 % of bankruptcy procedures were concluded in 2013, significantly less than in 2012 (35 %). In order to further strengthen market exit procedures, the legislation was amended to introduce shorter deadlines for bankruptcy procedures and allow out-of-court settlement in case of insolvency.

Regarding the free economic zones, domestic companies do not enjoy a level playing field with foreign companies as regards incentives. Conditions for obtaining public support implicitly favour (bigger) foreign firms, as local firms can rarely meet the required investment size. Government arrears still pose a problem for business' liquidity, despite the recently tightened legal requirements. ***Overall, while setting up a business has become slightly easier, difficulties remain as regards obtaining permits. Market exit remains lengthy, although the government has taken some reform steps in the right direction.***

Legal system

The government continued to implement judicial reforms aimed at speeding up procedures and improving capacities, notably by upgrading information and electronic delivery systems. At the end of 2013, the number of pending cases had been reduced by 9 %. Contract enforcement remains difficult for private companies, with lengthy and costly legal procedures, inefficient licensing procedures, and often uneven application of laws. The large size of the informal economy continues to hamper competition and the development of a formal private sector. There is little available information on the Labour Ministry's 2013 action plan for reducing the shadow economy, and the Minister presented a similar plan for 2014 without clear evidence of a results-based assessment of previous measures.

Business is still burdened by frequent new legislation without sufficient public consultation. Only 44.5 % of draft laws were published on the national electronic register in 2013 as opposed to 61.3 % in 2012. ***Overall, the legal system for a functioning market economy is largely in place, but inefficiencies arise in practice from lengthy procedures hampering enforcement of laws. Frequent changes of laws create legal uncertainty***.

Financial sector development

The country's financial system is dominated by the banking sector, about 89 % of the system's total assets, while the insurance sector, including fully-funded pensions, represents roughly 4 % of total assets. The size of banks' financial intermediation is important, with the assets-to-GDP ratio having risen gradually over recent years to about 80 % by the end of the first quarter 2014. On the positive side, concentration in the banking sector diminished somewhat, though 60 % of total assets are still owned by the three largest institutions. Banks are mainly funded by deposits, which recorded a sound annual growth rate of 7 % in the first quarter.

Financial stability indicators are resilient. Regulatory capital has diminished slightly, but is still far above levels required by banking regulation, and liquidity of banks remains ample. Profitability indicators point to strong performance, in particular in the second half of 2013 and beyond. The quality of loan portfolios has improved gradually since summer 2013, yet the ratio of non-performing to total loans to non-financial entities remains elevated, at 11.1 % at the end of March 2014. However, non-performing loans do not appear to pose a systemic risk, and are fully provisioned for. Private sector credit growth picked up again since the summer of 2013, after having declined since May 2012. Loan growth to companies began increasing only towards the end of 2013. Even though the share of domestic currency in total loans is increasing, about 50 % of loans are still denominated in foreign currency, posing potential market risks in case of adverse foreign exchange developments. A further risk might arise, in the mid-term, from potential parent-led restructuring, with negative impact on two of the biggest banks in the country, which together account for about 40 % of the sectors' assets. The capacities of supervisory bodies were strengthened through amendments, in March 2014, to the Law on Insurance Supervision and to the Securities Law, tightening selection criteria for members of the supervisors' decision-making bodies. ***Overall, the financial system remains stable, and supervisory capacities have been further strengthened. However, access to finance continues to be difficult, and the non-banking segments of the market need to be further developed, with a view to widening funding opportunities for the private sector. Measures should continue to be taken to repair the bank lending channel, including by fostering the clean-up of non-performing loan portfolios***.

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

Human and physical capital endowment

Low labour market participation, in particular of women, and limited job opportunities in advanced industrial sectors restrict the opportunities for developing the skills of the workforce. The level of education and training of the workforce does not correspond adequately to the needs of the economy. Recent improvements in access to education have produced good results, as the number of early school leavers dropped, and the rate of pre-school enrolment increased. The number of graduates from tertiary institutions dropped in 2013, but the overall share of workers with tertiary education has risen by 4pp to some 18 % of the workforce between 2009 and 2013. However, one quarter of them is unemployed, as most of the job creation in recent years took place in low-productivity sectors.

Labour productivity remains low at about 18.4 % of the EU average and has not recovered since the crisis-related drop in 2008/2009, in particular in manufacturing. The sectoral structure of employment is stagnant — the economy remains focused on agriculture (19 % of total employment) and trade, the much-needed transition to higher-earnings jobs has not yet taken place. Foreign companies, many of which are active in higher-end manufacturing activities, often face difficulties in finding the necessary skills in the workforce or set up supply chains with local companies to substitute for imports. The government continues to address the labour market challenges primarily through a wide variety of active labour market measures, including subsidised employment schemes and grants for start-ups. These measures are insufficiently prioritised on the basis of performance evaluation, and do not adequately address the underlying structural causes of unemployment. The variety of measures and the number of workers covered by these schemes has increased significantly in 2014. While the government has adopted a number of strategies addressing structural rigidities in the labour market, such as a vocational training plan, actual implementation is lagging.

Capital investment remains modest — in 2013, gross capital formation amounted to about 29 % of nominal GDP, which is below the levels of the preceding two years. There is an emerging dichotomy in the country’s capital stock, with foreign investment increasingly focused on higher-productivity, technology-intensive sectors, while the capital stock in the local economy remains low and relatively outdated. The state of transport and energy infrastructure hampers economic development in many areas — the government is addressing this obstacle through large-scale public investment projects, co-financed by international donors and commercial banks. The share of foreign direct investment in GDP remained relatively low, and only 40 % of the inflows took the form of greenfield investment in 2013. The overall stock of FDI is also relatively low at about 50 % of GDP. Yet its recent change in structure — from services and utilities to machinery and transport equipment — makes a small, but positive contribution to updating the capital stock. ***Overall, the government has made some progress in addressing the prevalent shortcomings in the country’s human and physical capital endowment, but the challenges of the investment required to accelerate labour productivity growth and the structural transformation of the economy remain very large. The government should continue to improve the composition of spending, by prioritising investment projects according to their productive potential on the basis of cost-benefit evaluations.***

Sector and enterprise structure

There was no notable change in the sectoral structure of the economy. At 36 %, trade, together with automotive-related services, dominated the enterprise sector. The share of agricultural output in the economy remains stagnant at about 10 %. Mainly due to the hesitant recovery of the manufacturing sector in 2013, the share of mining, manufacturing and utilities declined from about 21 % in 2011 to 16 % in 2013. The construction industry gained in importance, accounting for about 10 % of gross value added in 2013, up from 7 % in 2011, driven to some extent by public infrastructure investment, and by foreign investment.

In terms of size, the economy remains dominated by micro- and small enterprises, which accounted for more than 98 % of all companies in 2013. The number of large companies more than doubled, induced by the establishment of companies with foreign investment, even though their share remained well below 1 %. Small and medium enterprises accounted for over 80 % of total employment, with the share of large companies diminishing slightly to below 20 %. ***Overall, the sectoral and enterprise structure of the economy remains stagnant and focused on low-productivity activities. The recent increase in the number of large companies suggests that the share of more advanced manufacturing activities in the economy might strengthen somewhat in the coming years, but a genuine sectoral transformation remains elusive***.

State influence on competitiveness

The state's ownership of economic assets remained relatively moderate at about 15 % of GDP. The legal framework for state aid was strengthened by the adoption of regulations on regional aid, horizontal aid and Services of General Economic Interest, transposing the relevant EU legislation into national law. There is limited reporting on state aid. In the course of the second phase of the deregulation of the electricity market, which began in April 2014, 222 medium and large companies and started to purchase electricity on the open market. However, notwithstanding these developments, there is a wide range of policy instruments through which the government increasingly has an impact on the economy's — and on different sectors' and companies' — competitiveness, such as direct subsidies and tax exemptions, in particular for foreign investors; on-site firm inspections and fines; involuntary rescheduling of payment contracts; public guarantees for loans to state-owned enterprises; public infrastructure projects; and active labour market programmes. ***Overall, against the overall background of a low share of the state in the economy's assets, improved state aid legislation, and further deregulation of the electricity market, the state's influence on competitiveness through the implementation of other policy instruments seems to have increased.***

Economic integration and convergence with the EU

Total trade in goods and services remained high at about 126 % of GDP with exports totalling 54 % of GDP. In 2013, about 70 % of total exports went to the EU, some 7 % more than in 2012, and some 60 % (+2pp) of imports originated there. CEFTA was the second most important trading partner, at some 20 % of exports — less than in 2012 — and some 12 % of imports. Exports remain highly concentrated — 48 % of exports consisted of iron and steel, chemicals, and clothes. Yet, diversification continued, mainly on account of foreign investors, supporting a gradual shift to higher value-added products, such as machinery and transport equipment — its share in total trade increased to more than 13 % in 2013, from less than 5 % in 2008. Companies from the EU accounted for some 80 % of total FDI stock at end -2013. GDP per capita remained at about 35 % of the EU average in 2013. ***Overall, trade linkages with the EU have increased further in 2013, both on the export and import side, and the EU continues to account for the bulk of foreign direct investment***.

2.3. CONCLUSIONS

As regards the economic criteria, the former Yugoslav Republic of Macedonia remains well advanced and, in some areas, made some further progress in the establishment of a functioning market economy. To cope with competitive pressures and market forces within the Union in the medium-term, the country needs to address important challenges through determined implementation of structural reforms.

The economic recovery continued to progress, but it remains narrowly based on the external sector, and has had limited impact on unemployment which remains high especially among young people. Reforms addressing the structural rigidities of the labour market have progressed only hesitantly. Financial stability was preserved and FDI inflows increased. Fiscal discipline as well as transparency and quality of government spending deteriorated.

Prospects for growth and employment depend largely on the business environment of the domestic private sector. To support this, there is a need to further facilitate licensing procedures, also with a view to encouraging backward linkages between domestic and foreign firms; to speed up market exit procedures; and, generally, to ensure a level-playing field for all companies when enforcing business regulation. Access to finance will need to be improved, including by repairing the bank-lending channel. A better alignment of workers' skills with labour demand needs to be tackled through further reforms of the education system, including the implementation of the vocation training strategy. Regarding public finances, the renewed deterioration of fiscal discipline in 2013 and 2014 calls for improved budget planning procedures and better consistency of annual budget execution with the medium-term fiscal strategy. The quality of public spending should be improved, by shifting the composition of capital expenditure towards growth-enhancing investment

3. MONTENEGRO

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro's macroeconomic stability recorded some improvement and the economy recovered from the 2012 recession. However, several challenges hinder the efficient allocation of resources. The current-account and fiscal imbalances persist and domestic demand remains subdued as banks are not yet playing their intermediation role in the economy. Labour market conditions, as well as diversification and overall competitiveness are all still weak while key investments are at an incipient phase of development or delayed.

Economic policy

The government's third Pre-Accession Economic Programme (PEP), covering the period 2014-2016, presents a broadly consistent, albeit somewhat optimistic, medium-term macroeconomic and fiscal framework based on the projection of a gradual acceleration of growth from 3.6 % in 2014 to 3.8 % in 2016. The key objectives of the programme remain fiscal consolidation, achieving a nearly balanced budget in 2015, and improvements in the business environment to support economic growth. Overall, the political consensus on market economy fundamentals has broadly been maintained, with one particular exception concerning the resolution of the bankrupt aluminium firm (KAP) and its debt clearance. Montenegro needs to step up its efforts, in line with the conclusions from the ministerial dialogue between the economic and finance ministers of the EU and the candidate countries from May 2014 to set public debt on a declining path, reduce the high burden of banks' non-performing loans, and improve the business environment as well as labour market conditions.

Macroeconomic stability

The economy recovered from a double-dip recession in 2013, growing by 3.3 % after contracting by 2.5 % the year before, according to latest data from the national statistical office. Growth was largely driven by investments thanks to stronger activity in the construction sector, as well as by net exports fuelled by stronger external demand for electricity and for tourism services, but also by a sharp contraction of imports. Private and public consumption recorded some slight growth of around one percentage point in real terms. Investment expanded thanks to stronger activity in the construction sector. Tourism continues generating good results, but external shocks from floods in neighbouring countries and from tensions between Ukraine and Russia — that are important tourism markets as well as foreign direct investment (FDI) sources for Montenegro — cannot be discarded. Growth continued in 2014, with the economy expanding in the first two quarters by 1.7 % and 0.3 % year-on-year respectively, driven by investments (mostly construction) and some recovery in private consumption. However, industrial output turned negative in the first six months of 2014. While manufacturing and mining recorded some expansion, the sharp decline in utilities after an exceptionally high electricity output the year before, led to an overall decline in industrial production, down in the first half of 2014 by an average 15 % year-on-year. Moreover, downside risks to a sustained economic recovery persist as domestic demand remains subdued due to credit growth constraints, high unemployment, and falling wages. Growth recovery led to a modest rise in average per-capita income expressed in purchasing power standards to 42 % of the EU average in 2013, compared to 41 % a year earlier. ***Overall, the recovery remains fragile due to the weakness of domestic demand and high dependency on the external environment***.

Graph 3.1: **GDP and unemployment developments**

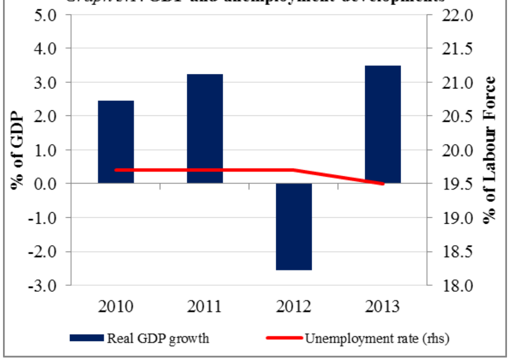
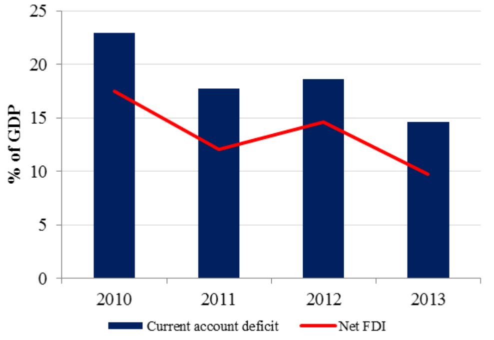


Table 3.1:
Montenegro - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	-5.7	2.5	3.2	-2.5	3.3	0.9
Private consumption	Ann. % ch	-12.9	2.0	4.2	-3.2	1.1	N.A.
Gross fixed capital formation	Ann. % ch	-30.1	-18.5	-10.3	-3.3	8.8	N.A.
Unemployment rate	%	19.1	19.7	19.7	19.7	19.5	18.8
Employment	Ann. % ch	-2.7	-2.2	-6.1	2.2	1.1	6.6
Wages	Ann. % ch	5.7	11.0	1.0	0.8	-0.2	-0.6
Current account balance**	% of GDP	-27.9	-23.0	-17.7	-18.7	-14.6	-14.8
Direct investment (FDI, net)**	% of GDP	35.8	17.5	12.0	14.7	9.7	10.0
CPI, average	Ann. % ch	3.4	0.5	3.1	4.1	2.2	-0.8
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
General government balance	% of GDP	-5.7	-4.9	-5.4	-6.1	-5.3	-1.7
General government debt	% of GDP	38.2	40.9	45.9	54.0	58.1	57.5

** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

Graph 3.2: **Balance of Payments developments**



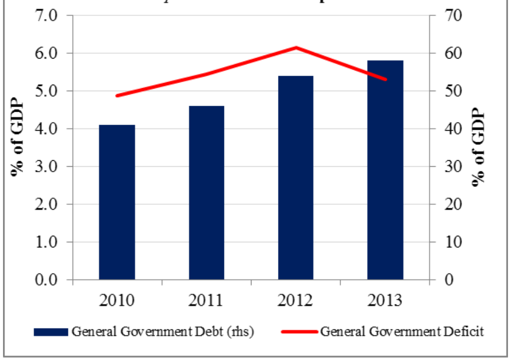
External imbalances are easing. The current-account deficit declined in 2013 to 14.6 % of GDP from 18.7 % a year earlier due to a stronger contraction of imports rather than an improvement in exports. Yet, the trade deficit remains one of the main structural problems, reflecting the local economy's narrow production base, lack of competitiveness and high import dependence. In 2013, the strong export performance of electricity was due to exceptionally favourable weather circumstances, and consequently exports in 2014 are more modest. In the first half of 2014, the trade deficit widened 4.5 % year-on-year as exports declined much faster than imports and the base effect from past energy exports faded off. As a result, in the four quarters to June the current-account deficit slightly increased to 14.8 % of GDP. So far, risks have been mitigated on the financing side. In 2013, total net capital inflows were greater than the current-account deficit, driven by net FDI inflows worth 9.7 % of GDP and by transfers. This allowed the central bank to increase its reserves. In the four quarters to June 2014, net FDI remained broadly stable at 9.6 % of GDP. ***Overall, despite some improvement, the sustainability of the external position remains a key challenge***.

Despite some marginal improvement, the unemployment rate remains very high, above 19 %, with a large predominance of long-term (82 %) and youth (42 %) unemployment. The 2013 employment and activity rates of the population aged 20-64 stand at a low 52.6 % and 65.1 % respectively. These weak labour market conditions are exerting downward pressure on wages, which continued to contract, weakening private consumption. ***Overall, labour market imbalances are reflected by persistently high youth and long-term unemployment.***

Given the unilateral use of the euro, the ability of the central bank of Montenegro to conduct monetary policy is limited. The strength of the euro together with lower international prices exert downward pressure on imported inflation from energy and food, while falling wages and tight credit conditions also added to the deceleration of prices. As a result, over the course of 2013, the average harmonised consumer price inflation declined to 1.8 %, from 4.0 % a year before. Disinflation turned into negative growth rates in January 2014, recording afterwards six consecutive months with negative consumer price growth, despite uninterrupted growth of retail sales during the same period. ***Overall, Montenegro faces a general fall in the aggregate price level, driven by a drop in global commodity prices in the absence of a proper monetary policy rather than by a decrease in aggregate demand***.

Fiscal reporting and accounting remains an issue. In 2013, the unplanned payment of state guarantees as well as substantial disbursements related to obligations from previous years for restitution, old foreign currency saving and some court decisions claims, brought the consolidated budget deficit to 5.3 % of GDP, up from the preliminary estimate of 2.3 %, albeit a marginal improvement compared to the 5.9 % deficit recorded a year earlier. Measures were adopted to boost revenue, including an increase in personal income tax and in the standard VAT rates while, in order to reduce expenditure, the government froze pensions and public-sector wages and cut capital spending. Unburdened from past liabilities, the cumulated budget deficit recorded some improvement in the first seven months of 2014, declining to 1 % of the full-year GDP compared to 3.6 % a year earlier, as budget revenue — supported by higher VAT and social security contributions — kept growing faster than expenditure. In the past, loans to cover state guarantees contributed to a further increase in public debt, which has doubled since 2008 to reach 58 % of GDP in 2013, although marginally declined to 57.5 % of GDP at the end of June 2014.

Graph 3.3: **Fiscal developments**



Montenegro's main policy challenge is to restore fiscal stability, together with curbing the large current-account deficit. The adoption of fiscal rules in April 2014 seems to confirm the continuity of consolidation efforts, although the efficiency of its enforcement mechanism needs to be verified once the law is implemented. However, expensive construction projects (prone to risks of delays and cost overruns) like the Smokovac-Mateševo highway section, may require additional measures to contain public debt within the fiscal rules threshold. Moreover, public finances are characterised by a high degree of non-discretionary spending and some persisting risks of slippages, over and above a sizable stock of state guarantees. ***Overall, as the fiscal position failed to improve despite consolidation efforts, the challenge of ensuring fiscal sustainability and steering the public debt in a downward trajectory remains***.

Interplay of market forces

The development of the private sector is financed through a sustained inflow of foreign investment facilitated by public property concessions and privatisations. State ownership of the economy is comparatively low and predominantly concentrated in transport and utilities, together with a few firms in the agriculture, publishing and tourism sectors. The aluminium conglomerate KAP, in which the state had a 29 % stake, was declared bankrupt in October 2013 after having accumulated debts worth several times the company's value. Its assets — divided into several groups — were sold to local companies in 2014, thus putting an end to the state's role as a shareholder. One of the former co-owners (CEAC) filed several complaints against the sale of KAP that were rejected by local courts. However, a Nicosia court adopted a decision banning the sale of KAP's assets. As a result, the sale of KAP remains on hold until the bankruptcy administrator can transfer the property free of litigation, with risks of a new round of contingent liabilities for the public finances. The state also had a 29 % stake in the Nikšić bauxite mines that were declared bankrupt in February 2014 but, in the absence of a reorganisation plan by the owners (i.e. the state and CEAC); the bankruptcy administrator offered the company's property for sale at the end of July although investors have shown no interest so far. Concerning administrative prices, these remain moderate, accounting for 7.4 % of the consumer price basket. ***Overall, state ownership of the economy has been reduced following the bankruptcy of the aluminium factory and bauxite mines***.

Market entry and exit

The number of new companies rose substantially in 2013 to 4 146, or 17 % more than the previous year. These figures must be treated with caution, however, as some of these might be former companies that have re-established themselves as a way of escaping debt. It remains difficult to obtain credit particularly for small and micro businesses, which have either very few, or, in most cases, no alternative means of financing apart from the banking sector, and therefore endure severe liquidity problems. The ongoing modernisation of public administration including the simplification of procedures and, ultimately, the creation of a more efficient administration remains a challenge for the years to come. In 2013, the number of companies liquidated as a result of bankruptcy proceedings declined markedly, totalling 217 or 25 % less than a year before. ***Overall, as the recovery takes hold, the number of Montenegrin companies is growing***.

Legal system

Uncertainties relating to the Montenegrin legal and judicial system may in some cases entail risks for economic agents. Laws sometimes contain ambiguous provisions and are therefore difficult to implement. Moreover, the outcome of judicial proceedings is difficult to predict as Court orders are not always enforced or followed by law enforcement institutions. Out-of-court resolution of commercial disputes through the mediation centre has made further progress, with both the number and the value of commercial disputes successfully resolved increasing.

Licensing, tax administration procedures, and contract enforcement are priority issues identified by the business community as key obstacles. In April 2014 the first public bailiffs started work on the task of improving contract enforcement. In early September 21 public bailiffs, out of a total of 32 stipulated by the law, had been appointed. Progress has been made on reducing municipal fees for construction permits and making it easier to obtain them by shortening deadlines, streamlining procedures and setting up one-stop shops. However, the business registration service has yet to be extended to all regional tax administration offices. In July 2014, the parliament adopted the Law on e-Government with a view to improve communication with the users of state administration services. The e-Government Portal was revamped, although only part of the administration has started working with electronic documents in a production environment. There has been little progress on the regulatory impact assessment project, which is intended to assess the regulatory framework and issue recommendations on simplifying regulation (e.g. by means of a ‘regulatory guillotine’). ***Overall, simpler and more predictable regulation of business and further efforts to tackle corruption are needed to improve the business climate.***

Financial sector development

The banking sector has remained stable. In May 2014, the central bank of Montenegro issued an operating licence for a new local one, raising to 12 the number of banks in the country. However, the number of entities does not seem to have had a noticeable impact on interest rates for new loans, which remain persistently high, at above 10 %. Risk premiums appear to be the main cause for the elevated lending rates. The sector is dominated by foreign banking groups, which account for 83.5 % of total bank capital. However, all banks are increasingly resorting to own deposits financing to offset the decline in foreign funding. Banks posted positive financial results in 2013 as well as in the first half of 2014, compared to substantial losses in 2012. Credit quality still remains a key concern as banks struggle with a large stock of bad loans. Thus, the banks’ credit activity remains constrained by the high level of non-performing loans (NPL), and burdened by lengthy procedures for banks’ collateral execution through the judicial enforcement of contracts. Despite a timid recovery([1]) in 2013, the total amount of credit to the economy contracted in the first six months of 2014.

In order to address this problem, the central bank adopted a decision in November 2013 requiring banks to develop resolution strategies for non-performing loans. However, the parliament still needs to adopt the law on voluntary financial restructuring known as the 'Podgorica approach'. This would provide a framework for out-of-court proceedings for restructuring the debts of economically viable companies, including through purchases of debtors' claims supported by tax and supervisory incentives. Meanwhile, some banks have offloaded part of their bad loans to factoring companies. However, factoring services are not regulated, creating legal uncertainties for some types of transactions. Hence, the authorities initiated in September 2014 proceedings to prepare a law on factoring with a view to improving the legal framework and establishing an appropriate level of supervision.

Altogether, the non-banking financial sector remains relatively small and underdeveloped. In 2013, the total annual market turnover of the stock market represented less than 1 % of GDP, while insurance companies' gross premiums accounted for some 2 % of GDP. However, some recent developments could help to expand these markets in the future. Thus, in May 2014, Montenegro's stock exchange recorded the first trade in government bonds, while the Insurance Supervision Agency delivered the first licence to a bank to engage in insurance operations.

***Overall, together with other measures, the swift implementation of the 'Podgorica approach' to tackling banks' non-performing assets will be instrumental in restoring bank lending and thereby support domestic demand*.**

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

Human and physical capital endowment

The high unemployment rate requires the gap between supply and demand for labour skills to be bridged by supporting labour mobility and by making active labour market policies and education more effective. Internal labour mobility remains a key issue. Montenegrins are reluctant to apply for seasonal jobs (which account for some 70 % of the total offer of employment) and employers resort instead to recruiting workers from neighbouring countries.([2]) Standard active labour market programmes have been implemented with relatively few funds, focusing on finding work for young people and seasonal workers. Based on evaluations, more effective and outcome-oriented active labour market measures should be expanded, with greater emphasis on the poorest areas of the country. There is also a need to increase the quality of education, particularly vocational education and adult learning.

A number of major infrastructure projects in energy, transport and tourism are being developed in an effort to diversify and strengthen the economy. The electric power company is in the process of selecting the bidder for the construction of a new block for the thermal power plant. Once completed, this plant will reinforce energy independence (including from weather conditions) with the potential to gradually turn -together with two planned hydropower plants- the country into a net exporter of electricity. Meanwhile, construction works for the electricity interconnection with Italy and the

([1]) Note: the introduction of international accounting standards (IAS) in the banking sector as of January 2013 hinders data comparability.

([2]) To illustrate the mismatch between demand and supply, note that in 2013 there were 48 900 unemployed persons despite an offer of 37 869 job vacancies. In addition, 22 498 work permits for foreign workers were delivered to cover employers' needs.

reinforcement of the transmission grid are ongoing. In June 2014, concession contracts for building 10 small hydropower plants were signed. On transport infrastructure, in May 2014 the government adopted a law on the Bar-Boljare highway, and in September, the Chinese Exim Bank approved the loan for this project, providing for construction work to start by the end of 2014. The container and general cargo terminal in the port of Bar started investing in new equipment. Construction of two large tourist resorts started at the end of 2013, and concessions for developing new ones are at different stages of development.

Montenegrin institutions have started to participate more actively in international programmes run by the EU and in bilateral cooperation with EU Member States. The funds allocated to research and development (R&D) programmes increased in 2014; a centre of excellence in bioinformatics (BIO-ICT) began operations in July 2014 and plans for the establishment of a science and technology park (Technopolis) are advancing. The Ministry of Science continued co-financing in 2014 the second research year, counting with 104 national projects, although total R&D financing (at some 0.5 % of GDP) still appears modest. Moreover, private sector participation in R&D remains low.

Overall, further efforts are required on research, development and innovation to strengthen the competitiveness of domestic companies as well as on building the necessary infrastructure to support sustainable expansion of the economy. Pursuing education reform to reduce the skills gap, strengthening active labour market policies, and introducing more flexibility in the labour market through distinct collective agreements for the public and private sectors are essential to reduce unemployment.

Sector and enterprise structure

The structure of the economy has changed in the last decade. It is no longer driven mainly by industrial production — metallurgy, in particular — but by the service sector, mainly tourism, together with transport, retail sales, and to a lesser extent, construction and energy production. While the restructuring of the aluminium industry remains uncertain, the renovation of the steel mill by its new owner is well underway. The company, acquired in May 2012 following bankruptcy by its former owners, has invested in new machinery and, on completion — planned within two years — production capacity is expected to increase substantially. Furthermore, the new owner is in the process of procuring two other companies; a machine builder and a foundry located next to the steel mill. In the network industries, various services of the port of Bar have been privatised. The railways and Montenegro Airlines are being restructured and listed — for several years now — for privatisation. In the energy sector, the state remains the major shareholder in the electric power company EPCG, and increased its share by two percentage points to 57 % after the company’s tax arrears were converted into equity in July 2014. However the influence of the state remains contractually limited as the privatisation contract — by which an Italian investor acquired a participation of more than 40 % — also assigned the management rights to the company. The state also retains a majority stake (55 %) in the electricity transmission system operator CGES.

Public-sector support schemes for small and medium-sized enterprises (SMEs) remain limited. The — de facto — development bank of Montenegro (the Investment and Development Fund), provides support through a variety of instruments, mainly credit lines, but also credit guarantees, factoring, and to a lesser extent, support for start-up businesses, export promotion programmes and studies. However, the fund’s financial capacity to sustain all these activities appears modest (around 1 % of GDP per year). The government is also supporting the economic development of the less developed regions. It has adopted development plans for six municipalities, set up two new business zones, and provided incentives for five industrial clusters dealing with agro-food and forestry products. In addition, the government continued the efforts to reduce the informal economy by stepping up checks on excise goods, retail trade, and labour.

Overall, the economy is going through a transformation process, reinforcing the services and energy sectors while older industries like metallurgy and transport are being restructured.

State influence on competitiveness

The aluminium conglomerate has severely drained public funds. Between its privatisation in 2005 and its recent liquidation in June 2014, KAP cost the government some € 350 million in state guarantees and subsidies for electricity, in addition to unpaid taxes and social security contributions. The total amount of state aid granted in 2013 reached 3 % of GDP compared to 1.3 % a year earlier. The activation of state guarantees accounts for a substantial share of this aid in the last two years. The general government budget foresees a substantial decline in state aid for 2014, planning 0.6 % of GDP for subsidies in addition to 0.3 % of GDP for state guarantees -already disbursed- in the first half of this year. However, other forms of state support, apart from direct budgetary transfers, are also available, either from the Investment Development Fund, or through grants and loans for agricultural producers. Investors may also benefit from tax exemptions (usually releases from municipal utility fees while premises are under construction). In addition, for some very large projects of strategic importance, ad hoc measures may be adopted to help the investor, like the law on the Bar-Boljare highway, granting exemption from VAT and custom duties. ***Overall, after the liquidation of the former aluminium conglomerate, the allocation of state aid funds has dropped markedly.***

Economic integration and convergence with the EU

Montenegro remains a very open economy. In 2013, the total trade of goods and services was close to 104 % of GDP, albeit down from 113 % the year before. Exports of goods and services totalled 42 % of GDP in 2013, according to the latest national data. Merchandise exports to the EU represented 41 % of Montenegro’s total exports compared with 49 % to CEFTA countries, while goods from the EU remain predominant, accounting for 44 % of total imports compared with 39 % from CEFTA. In services and foreign investment, Russia remains Montenegro’s single most important partner, accounting for 28 % of tourism stays and of FDI inflows. The EU accounts for 20 % of tourism and 39 % of foreign investment, while CEFTA’s contribution stands at 36 % of the tourism total, but only 4 % of FDI inflows. Since 2011, Montenegrin exports have gained some marginal competitiveness as wages have continued to contract in real terms. ***Overall, further efforts are still necessary to strengthen export capabilities and the integration of Montenegrin businesses in the common market***.

3.3. CONCLUSIONS

As regards the economic criteria, Montenegro undertook some further steps 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 structural reforms.

The economy recovered in 2013 from a double-dip recession, but the recovery remains fragile due to weak domestic demand, a narrow production base, and a high dependence on the external environment. The current account deficit somewhat narrowed but external imbalances remain high. Substantial and persistent budget deficits point to the need for fiscal consolidation measures to ensure a reduction of public debt. In spite of marginal improvements, the labour market conditions remain precarious in view of very high unemployment rates, especially among the youth and the long-term unemployed.

Montenegro should increase workers mobility and strengthen the effectiveness of active labour market policies, as well as enhance the quality of education, including vocational education and training. To support private-sector development, measures should be taken to further simplify the regulatory and legal environment, including strengthening contract enforcement, reducing administrative costs and barriers, and facilitating privatisation procedures. The unsettled situation of the aluminium conglomerate KAP calls for a sustainable solution, implemented in compliance with SAA rules, in order to avoid a new round of contingent liabilities.

4. SERBIA

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

State presence in the economy remains significant. The private sector is weak and unprotected as the rule of law is not systematically observed. The new government has a mandate for economic reforms but their implementation has progressed slowly. Although external deficits declined strongly, fiscal imbalances remain very high and structural rigidities and obstacles to growth still need to be addressed. The functioning of market mechanisms remained hampered by significant distortions and legal uncertainty.

Economic policy

In January 2014, the government submitted to the Commission its Pre-Accession Economic Programme for the period 2014-16. The main objectives of the programme are economic recovery and stabilising government debt below 70 % of GDP. To this end, the government has proposed a number of fiscal consolidation measures and structural reforms. Key legislation related to improving the business environment has been recently adopted but the authorities would need to step up their efforts to implement the envisaged reforms, in line with the conclusions from the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Candidate Countries from May 2014. The Ministerial Dialogue provided policy guidance on a number of macroeconomic challenges and structural reforms with particular emphasis on fiscal consolidation, public administration reform and privatisation. Delays in the implementation of reforms led to the resignation of the finance minister in July and discussions with the International Monetary Fund on a new pre-cautionary Stand-By Arrangement have remained inconclusive. Reducing the very high budget deficit and taming government debt would require additional efforts. Fiscal consolidation needs to be further strengthened and frontloaded. ***Overall, commitment to economic reforms exists, but significant efforts are needed to strengthen fiscal consolidation and accelerate the implementation of the announced structural reform measures***.

Macroeconomic stability

Following an export-led recovery last year, the economy contracted in the first half of 2014. Small pockets of growth remained isolated, suppressed by weak domestic demand. Net exports have been the major driver of economic activity and underpinned a continuing rebalancing of the economy away from consumption. After a slump in 2013, investments remained subdued in the first half of the year, despite increased government capital expenditure. In addition, heavy floods in the spring have hit agriculture and damaged transport and, in particular, energy infrastructure, further undermining short-term growth. Average per capita income, expressed in purchasing power standards, increased to 36 % of the EU average in 2013 from 35 % in the previous year. ***Overall, impacted by heavy floods the economy contracted in the first half of 2014. Exports remained the only engine of growth***.

Graph 4.1: **GDP and unemployment developments**

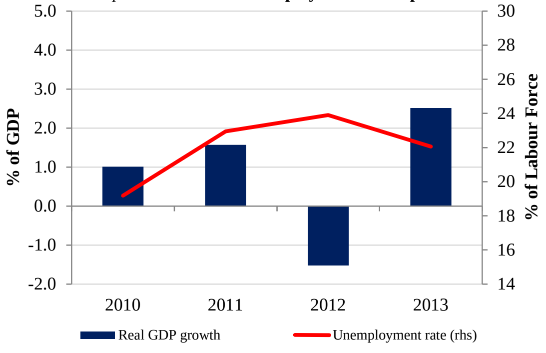
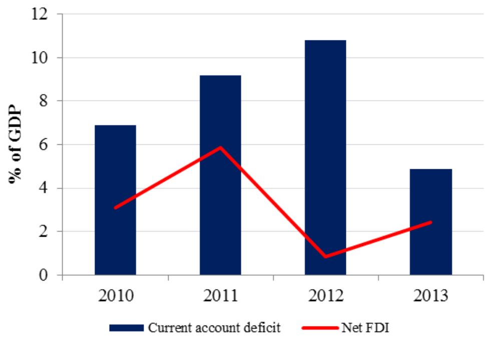


Table 4.1:
Serbia - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	-3.1	0.6	1.4	-1.0	2.6	-0.5
Private consumption	Ann. % ch	-2.7	-1.0	-1.2	-1.9	-1.5	-2.1*
Gross fixed capital formation	Ann. % ch	-22.1	-5.5	8.4	14.4	-7.7	-6.3*
Unemployment (>15 years old)	rate %	16.1	19.2	23.0	23.9	22.1	20.6
Employment (registered)	Ann. % ch	-6.1	-3.6	-3.1	-1.1	-1.0	-1.8
Wages (average, net real)	Ann. % ch	1.0	7.4	11.1	9.0	5.7	1.0
Current account balance**	% of GDP	-6.2	-6.5	-8.6	-11.5	-6.1	-5.9*
Direct investment (FDI, net)**	% of GDP	4.5	2.9	5.5	2.2	3.7	4.3*
CPI (end of period)	Ann. % ch	6.6	10.2	7.0	12.2	2.2	1.8
Exchange rate RSD/EUR	Value	93.94	102.90	101.96	113.01	113.09	115.67
General government balance	% of GDP	-4.2	-4.4	-4.6	-6.1	-4.7	-7.6*
General government debt	% of GDP	32.1	40.8	44.2	55.9	58.8	64.2*

* Q1 ** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

Graph 4.2: **Balance of Payments developments**

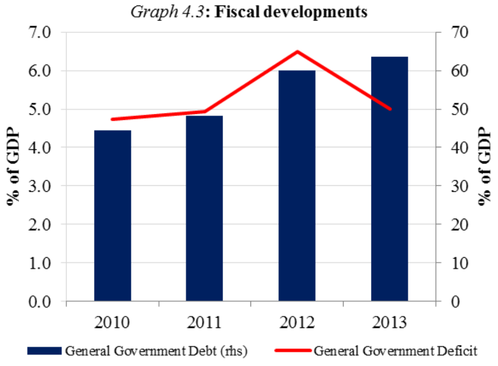


External imbalances fell strongly, mainly due to stellar export performance. The current account deficit almost halved in euro terms last year, dropping to around 6.5 % of GDP, and continued falling in 2014. Exports of goods and services in euro terms kept growing by double-digit rates, while imports remained restrained due to weak domestic demand. Net foreign direct investment rose slightly on the previous year, but is still far below its pre-crisis levels, representing 3.8 % of GDP in 2013. Most foreign direct investment went into trade, construction, real estate and financial services. After falling in the first months of the year, the central bank's international reserves have recovered, covering more than seven months' worth of imports. External debt has been fairly stable in euro terms, but fell in relation to GDP to around 80 % by the end of June. ***Overall, strong export growth contributed to a further narrowing of external imbalances.***

Unemployment stood very high at an average of 22.1 % in 2013. According to the Labour Force Survey (LFS), it remained above 20 % in the first half of 2014. The number of registered employed has steadily declined and a fifth of total employment is in agriculture and about a third in the public sector, revealing deep-seated structural problems. According to the LFS, informal employment remains substantial and has further increased. The activity rate of the population aged20-64 is comparably low at 66 %, as is the employment rate, which stood at 51.2 % in 2013. In a step towards reversing growing public employment, the government adopted a partial hiring freeze in January. However, strict implementation of the envisaged public administration reform is needed to streamline the bloated public sector and to tackle the unfounded salary differentials in the public administration. Long-term and youth unemployment are very high and active labour market programmes remain underfunded. Following a few months of real growth in the autumn, gross wages fell throughout most of the period and by an average of 1.0 % in the first seven months of 2014. A number of labour market rigidities have been addressed with the recently adopted revision of the Labour law. ***Overall, deep-seated structural problems and a weak economy keep unemployment very high. Recent legislative changes have addressed important labour market rigidities***.

The National Bank of Serbia continued pursuing inflation targeting, reaffirming its target of 4 %, ±1.5 percentage points. After staying at the average of 7.8% in 2013, inflation decelerated strongly, influenced by weak demand, a relatively stable exchange rate, dampened food prices after a good harvest and further reduction of tariff protection under the Stabilisation and Association Agreement. Since October 2013, monthly inflation rates have averaged 0.1 % until August and year-on-year inflation stayed mostly below the target band, the central bank missing its target for six consecutive months. Inflation expectations have declined as well, but in order to anchor them further and reduce inflation volatility, stronger competition on product markets and fiscal consolidation efforts will be crucial. The central bank reduced its key policy rate only gradually, from 11 % in September 2013 to 8.5 % by mid-June 2014. The dinar had remained broadly stable against the euro until late July, supported by central bank interventions mainly in the first months of the year, before coming again under depreciating pressures recently. ***Overall, weak demand, dampened food prices and the relatively stable dinar brought a period of very low inflation, even below the target band of the central bank.***

Graph 4.3: **Fiscal developments**



Despite a series of consolidation efforts, the fiscal situation remains precarious. The 2013 general government deficit of 5.0 % of GDP greatly exceeded the initial target, although it came in below the 2012 deficit. Budget execution was marked by significant revenue underperformance and the deficit was contained only by spending cuts, in particular of public investment, which suffered a serious blow and was reduced by a third from its medium-term average. Interest expenditure reached a new high of 2.6 % of GDP, eating up a quarter of the space generated by consolidation efforts. The 2014 budget envisaged an increase in the deficit to 5.5 % of GDP to finance mainly higher investment and interest payments. This does not include expenditure amounting to 1.6 % of GDP, such as servicing activated guarantees, financial system support, and the assumption of obligations from other entities. A new round of consolidation measures was implemented at the beginning of the year, which saw the reduced VAT rate raised from 8 % to 10 %, progressive reduction of public sector wages and limitations on public sector employment. Amendments to the pension and disability insurance law were adopted in July — a welcome step towards improving the long-term sustainability of the pension system. Penalties for early retirement were introduced and the retirement age for women is set to gradually increase to 65 years, equalising with that for men in 2032. Other reforms, with a potentially large budgetary impact, like finalising the process of enterprise restructuring or improving the efficiency of big state-owned companies, suffered continuous delays. A process of modernisation of costly public administration was launched with the adoption of a public administration reform strategy in the end of 2013 but more efforts would be needed for its sustained implementation.

Repeating a pattern from previous years revenues underperformed and, by the end of July, the budget deficit expanded by 21 % to 2.7 % of the expected GDP. To stimulate the flagging economy and employment, the government introduced a set of new measures ranging from tax breaks for new employment, to lending, construction and investment subsidies. However, some of these subsidies are of questionable efficiency and might further erode competition and weaken the fiscal situation. The weak budget performance and reconstruction needs, following the spring floods, prompted the announcement in September of a budget revision, which is likely to include progressive cuts of public sector wages and pensions. The significant fiscal imbalances have led to a further increase of government debt, which has approached 70 % of GDP. ***Overall, despite a series of new measures, fiscal imbalances remain very high. Significant further efforts are required to reduce government***

expenditure and implement the announced structural reforms in order to restore fiscal sustainability and improve the credibility of the consolidation programme.

Falling external imbalances reduced some of the pressure on the dinar and, coupled with weak domestic demand, have brought a period of very low inflation. However, monetary policy remained relatively restrictive in view of the significant external risks and domestic uncertainty. Therefore, achieving a proper policy mix depends on stepping up reform efforts and implementing a strong and credible medium-term fiscal adjustment programme, which will also allow for a more accommodative monetary policy.

Interplay of market forces

The state continues to hold dominant positions in major sectors such as energy, transport and telecommunications. The law on public companies, setting criteria and delineating a procedure for management appointments, has not yet brought about visible improvement in public companies′ governance and they continued to be largely overstaffed and inefficient. The envisaged restructuring of Srbijagas, the state-owned gas incumbent, has been delayed and has not started yet. The company has accumulated further losses as other public companies using its service are not paying their bills. The announced reorganisation and corporatisation of Elektroprivreda Srbije, the state-owned power utility company, has been launched in August with changes increasing the control of the company over its subsidiaries. ***Overall, the slow process of restructuring of the big state-owned companies is having a negative impact on public finances and the rest of the economy and needs to be urgently addressed***.

With the exception of the establishment of a strategic partnership between the national air carrier and Etihad, privatisation efforts have only been revived in summer 2014. After some 26 companies in restructuring went bankrupt, there was little further progress and around 160 companies, employing more than 50 000 people, continued to be protected from forcible collection of debts and bankruptcy. The companies in restructuring have accumulated significant liabilities through the years, representing a serious contingent risk to public finances and a heavy burden to potential investors. A new privatisation law was enacted in August, setting the end of 2015 as a deadline for completing the privatisation process and outlining the possible models of privatisation — strategic partnership, transfer of capital without compensation, sale of capital and sale of assets. In line with the law, in mid-August the Privatisation Agency invited investors to show their interest in the sale of 502 companies. By mid-September, the agency received 1 732 letters of interest concerning 403 companies. ***Overall, the state presence in the economy is significant and the privatisation process was revived only in summer 2014. Companies in restructuring remain a heavy drain on the budget and the economy***.

Market entry and exit

In 2013, the number of companies newly established (8 574) was more than three times the number of companies closed (2 562). However, market entry has continued to be burdened by lengthy and costly procedures for obtaining various specific permits and rising parafiscal charges. This is particularly valid for construction permits. The issue of converting usage rights into ownership rights has not been solved, which further hinders potential investment. Problems with construction permits are meant to be addressed shortly by amendments to the Law on Planning and Construction. In the first half of the year, the number of insolvent companies fell by 5 % to 37 711. However, those in insolvency for more than 180 days continued to increase, representing more than three quarters of all. In August, amendments to the bankruptcy law were adopted, regulating more in detail the role of the bankruptcy administrator and creditor rights. ***Overall, some steps were taken to resolve shortcomings in bankruptcy legislation. Red tape, parafiscal charges and difficulties in obtaining construction permits remained major obstacles to more dynamic business creation and expansion. Further efforts are needed to implement the planned reforms in this area***.

Legal system

Many laws, important for structural reforms and socioeconomic development, are still adopted without proper consultations with businesses and other social partners thus excluding them from dialogue on a better regulatory environment. Moreover, the implementation of laws remains problematic as there are long delays in the adoption of bylaws. The judicial system is slow in enforcing property rights, which adds to uncertainty and the cost of doing business. The backlog in the courts is still substantial and companies 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 2014, about 18 % of all submitted claims had been resolved. Several high-level cases of corruption have been prosecuted, but the number of final verdicts is low. Corruption remains a major threat to the business environment. ***Overall, legal predictability and enforcement of court decisions remain weak. Significant efforts are needed to strengthen the legal system and ensure even implementation of laws, as a crucial part of the business environment.***

Financial sector development

The banking system continued to face challenges and lending activity deteriorated further, falling by 6.1 % by the end of March. Corporate lending fell the most as banks tightened their lending terms and demand for loans weakened. However, the restarting of government subsidised lending boosted credit activity and slowed down the fall in bank claims on the non-government sector to 2.7 % in July. The domestic deposit base expanded further and banks remained highly liquid, although this liquidity did not spill over to the real economy. Euroisation continued to be widespread, with about three quarters of deposits and of loans to households and businesses denominated in or linked to foreign currency. Deteriorating economic activity pushed non-performing loans up, mainly in the corporate segment, to a new high of 23.0 % in the second quarter of 2014. Bank profitability also suffered and in 2013 the system as a whole registered negative returns on assets and equity. However, most of the losses were concentrated in a few banks and the system turned profitable again in early 2014. The regulatory capital adequacy ratio remained consistently high and stood at around 21 % at the end of June, well above the required minimum of 12 %.

Financial intermediation declined and banking sector assets stood at 92.4 % of GDP at the end of 2013. Banks and, in particular, foreign-owned banks, continued to dominate the financial system, accounting for most of the assets and liabilities. Weak governance led to the failure of some of the small banks. In the last two years, four banks had their licences revoked for failing to align their capital and performance ratios with the law on banks, which cost the state a total of about € 1 billion. In December, the central bank adopted a strategy for implementing the Basel III standards in Serbia. Limited measures were adopted to address non-performing loans. ***Overall, lending activity declined and the banking system, although well capitalised and liquid, continued to face challenges. The issues of improving corporate governance and the high burden of non-performing loans still need to be effectively addressed***.

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

Human and physical capital

The mismatch between the available human capital and economic needs is significant, leading to low labour market participation and high unemployment. Employment creation is limited, reflecting narrow production base and structural rigidities. Human capital fundamentals are very weak as declining population, emigration and population ageing undermine long-term growth potential. Unemployment among the youth and those with lower and intermediate education remains above the average. Although the number of pupils has declined steadily, employment in the education sector continued to increase. Inefficiencies of the education system are also revealed by the long average length of university studies and the significant number of unemployed with a university degree. A reorganisation of the schools network, the introduction of funding per student as planned from next year, and the implementation of the education strategy adopted in 2012 should improve the quality of education. ***Overall, significant efforts are needed to improve the quality and efficiency of the education system.***

The physical infrastructure would require sustained and large investments to improve and upgrade it. Floods in the spring have additionally impaired infrastructure in vast areas of the country and placed an additional burden on the already modest public investment funds. Due to fiscal constraints, government investment fell by more than a third last year but started recovering in 2014, when it grew by 26 % the first seven months. Furthermore, in the short-term, public investment is expected to be boosted by international aid, linked to reconstruction efforts after the floods. The government has continued its efforts to attract foreign financing for strategically important projects. However, its approach to attracting strategic investors has often been non-transparent and with a potentially adverse impact on public finance. Consideration should be given to finding a systemic and transparent approach for attracting private capital to cover at least part of the large investment needs. ***Overall, the physical infrastructure is underdeveloped and was further damaged by heavy floods. Reducing the budget deficit and improving the performance of publicly owned companies is needed to create space for infrastructure investment****.*

Sectoral and enterprise structure

The sectoral structure of the economy remained broadly unchanged. Agriculture activity, highly sensitive to weather conditions, recovered strongly last year and increased its share of gross value added to 11.4 %, but is set to fall again following the floods in 2014. Industry’s share increased slightly to 25.3 %, while that of construction and services fell to 3.3 % and 62.7 % respectively. Nevertheless, intrasectoral changes were noticeable; in particular, manufacture of refined petroleum products and of motor vehicles, linked to foreign direct investment made in previous periods, increased their share of total manufacturing and the information and communication sector continued to gain importance, also recording a marked increase in employment. The economic weight of the small and medium-sized enterprises is significant, representing more than half of the value added in the economy and about two thirds of employment. According to various surveys, SMEs suffer mostly from the weak financial and liquidity situation and the unpredictable regulatory environment. The SME sector is also negatively affected by unfair competition of the large informal economy.

As regards network industries, the lack of unbundling of the gas utility continued to hamper competition and market development. The gradual liberalisation of the electricity market progressed slowly with the opening up of the medium-voltage network. However, low prices, compared to the region, suppress actual competition and the state-owned company continued to dominate the market. The telecommunication market was further liberalised with the introduction of fixed number portability in April. ***Overall, the economic structure is changing slowly, driven mainly by foreign direct investment, but important sectors of the economy need further restructuring and liberalisation.***

State influence on competitiveness

State-owned, monopolistic structures dominate many sectors and the state continued to subsidise them heavily. Since the beginning of 2014, until the end of July, government subsidies expenditure increased by a real 7.1 %. Contrary to previous years, the annual State aid report for 2013 has been delayed and was not available by the time of writing this report. 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. ***Overall, the state continues to substantially and negatively influence competitiveness by providing significant and wide-ranging forms of state aid. The system of state aid needs to be thoroughly reviewed***.

Economic integration with the EU

The openness of the economy increased and total exports of goods and services reached 44.7 % of GDP, while imports stood at 56.4 % of GDP in 2013. The EU (including Croatia) increased its trade with Serbia and remained by far the country's main trading partner with 62.8 % of total exports of goods and 61.8 % of total imports of goods. 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 60 % in 2012 to 72 % in 2013. The share of net foreign direct investment from the EU in total FDI stood at 72 % in 2013. In real effective terms (deflated by inflation), the dinar has remained broadly stable since mid-2013. ***Overall, economic integration with the EU increased further and export performance improved, albeit from a low level***.

4.3. CONCLUSIONS

As regards the economic criteria, Serbia has made limited progress towards establishing a functioning market economy. A wide range of structural reforms needs to be implemented so as to cope in the medium-term with the competitive pressures and market forces within the Union.

The economy contracted in the first half of the year, also impacted by heavy floods. The government has made a serious start on its ambitious programme of economic and structural reforms with the adoption of a first set of important laws on labour, privatisation, and bankruptcy. Despite a series of new measures, fiscal imbalances remain very high and government debt continued to increase. However, growing exports contributed to narrowing of external imbalances. Inflation hit historically low levels, under the targeted band of the central bank. Unemployment remained very high.

Significant efforts to reduce government expenditure and implement the adopted structural reforms are required, in order to restore fiscal sustainability and ultimately support growth. Reducing the heavy state influence in the economy requires tackling inefficiencies in the large public sector, advancing privatisation in line with the schedule, streamlining state aid, and improving corporate governance of public companies. Tax collection needs to be improved, also by tackling the large informal sector. The business environment suffers from excessive red tape, slow market entry and exit, many obstacles to investment, such as the weak legal system and slow contract enforcement. The high share of non-performing loans needs to be effectively addressed to improve bank lending. Upgrading the physical infrastructure, especially after the damage incurred by the floods, requires persistent efforts and creation of additional fiscal space. The education system needs to be made more efficient in view of falling numbers of pupils and the skills mismatch in the labour market.

5. TURKEY

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

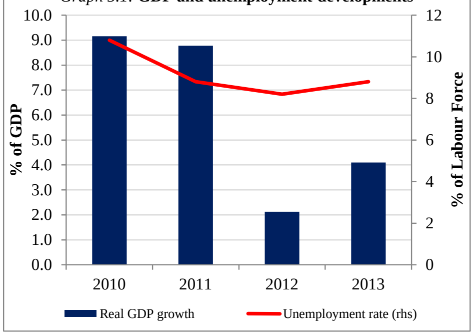
Turkey's solid growth performance since 2001 confirms the economy's improved fundamentals and increased resilience to shocks. However, the large structural current account deficit and relatively high inflation indicate the persistence of significant underlying imbalances in the economy. The functioning of market mechanisms has remained appropriate, but Turkey needs to reduce macroeconomic imbalances and take steps to realise its long-term growth potential.

Economic policy essentials

The pre-accession economic programme for 2014-16, submitted to the Commission in February 2013, is based on assumptions of relatively moderate growth, declining inflation, and a reduction of the fiscal and current account deficits. However, even in this optimistic scenario, the external deficit remains large, making 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 policymaking. It seems that economic policymaking has recently been affected by internal political tensions. ***Overall, the consensus on economic policy essentials has apparently weakened. Turkey needs to take steps to reduce the macroeconomic imbalances and to realise its long-term growth potential.***

Macroeconomic stability

Graph 5.1: **GDP and unemployment developments**



Following a slowdown in 2012, the Turkish economy accelerated to 4.0 % annual growth in 2013 which is somewhat below the long-term average since 2001. Consumer spending was the main driver for the upwards trend, while private capital spending remained subdued. Public expenditure, particularly investment, was a significant support for GDP growth. Net exports, on the other hand, exerted a drag on GDP growth in 2013 as exports of goods and services, corresponding to 25.7 % of GDP, stagnated and imports surged. In the first half of 2014, GDP growth weakened to 3.3 % year-on-year as private domestic demand decelerated in light of tighter financial conditions, macro-prudential measures to rein in household borrowing, and some indirect tax increases. The slowdown in private domestic demand was offset by rebounding exports which benefited from a more competitive exchange rate and some recovery in export markets, while imports declined slightly. GDP per capita based on purchasing power parity amounted to 55 % of the EU average in 2013. ***Overall, economic growth has been relatively moderate over the past year, with recent growth based on improving net exports.***

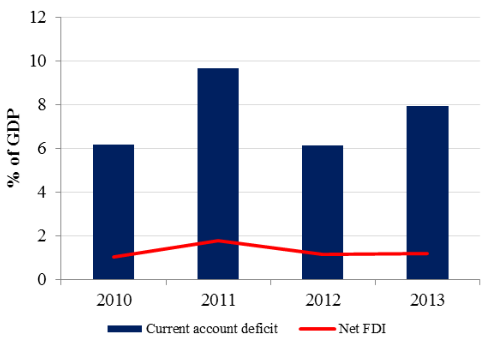
Table 5.1:
Turkey - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	-4.8	9.2	8.8	2.1	4.1	3.4
Private consumption	Ann. % ch	-2.3	6.7	7.7	-0.5	5.1	1.8
Gross fixed capital formation	Ann. % ch	-19.0	30.5	18.0	-2.7	4.2	1.9
Unemployment rate	%	13.0	11.2	9.2	8.4	9.1	9.5
Employment	Ann. % ch	0.1	6.0	6.3	3.1	2.8	5.2
Wages	Ann. % ch	9.9	11.8	9.7	11.5	12.4	15.1
Current account balance**	% of GDP	-2.0	-6.2	-9.7	-6.1	-7.9	-7.0
Direct investment (FDI, net)**	% of GDP	1.2	1.0	1.8	1.2	1.2	1.3
CPI, average	Ann. % ch	6.3	8.6	6.5	8.9	7.5	8.7
Exchange rate TRY/EUR	Value	2.16	1.99	2.33	2.31	2.53	2.97
General government balance	% of GDP	-6.5	-2.9	-0.8	-1.5	-1.6	N.A.
General government debt	% of GDP	46.0	42.3	39.1	36.2	36.3	N.A.

** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

Turkey's current account deficit has remained very high by all standards, averaging 7 % of GDP over the past two years. The deficit widened to 7.9 % of GDP in 2013, but this increase was due to volatility in Turkey's external trade in gold and is largely unrelated to the economy's underlying international competitiveness. Helped by some normalisation in the gold trade, the current account deficit narrowed in the first half of 2014, lowering the 12-month rolling deficit to 6.6 % of GDP in June. The persistently large current account deficit leaves the Turkish currency vulnerable to a sudden loss of investor confidence, as seen in the period between May 2013 and January 2014, when capital outflows temporarily lowered the value of the Turkish lira by up to 25 % against the euro. Only a relatively small proportion (14.7 %) of the current account deficit was financed with net inflows of foreign direct investment in 2013. Net portfolio investments covered twice as much (28.3 %) of the deficit and most of the remainder (47.0 %) was met by banks' foreign borrowing. While gross external debt amounted to a still manageable 53 %, its increase by about 15 % in the course of 2013 was comparatively high. ***Overall, the external deficit has remained very high and its short-term financing makes the country vulnerable to sudden changes in global investor sentiment.***

Graph 5.2: **Balance of Payments developments**

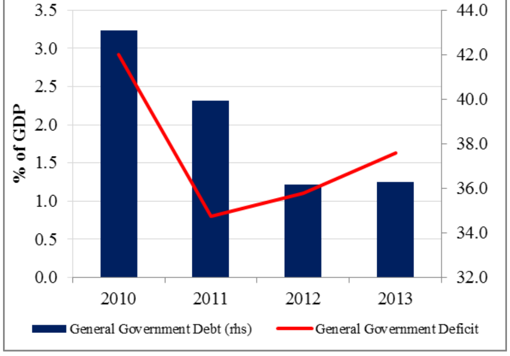


The labour market performance was mixed in 2013. For the population aged 20-64, the annual unemployment rate went up by 0.6 percentage points to 8.8 %, because the size of the labour force increased more than the opportunities for employment. Labour force growth (3.5 %) was mainly driven by demographics, but also by a 1 percentage point rise in the labour force participation rate to 58.4 %. The annual employment rate rose slightly to 53.4 %. In the first five months of 2014, labour force growth continued to outpace employment growth, leaving the unemployment rate half a percentage point higher year-on-year on average. The female employment rate remained very low, at 31.8 % in 2013, although it was up by 1.1 percentage points compared to the preceding year. 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 to be employed are unpaid family workers in the agricultural sector. The high proportion (25.5 %) of young people not in employment, education or training remains a concern. The efficient functioning of the labour market continues to be impeded by a lack of flexibility, for example on labour contracts, and undeclared work remains a widespread practice. This calls for a deepening and widening of labour market reforms which needs to be more inclusive, too. ***Overall, employment has increased at a rate commensurate to output but this has been insufficient to fully absorb the increase in the labour force. The female employment rate has edged higher, but remains at a very low level.***

The central bank has continued to conduct monetary policy within an unconventional framework. Although price stability is the primary objective, the central bank is also pursuing macro-financial stability, attaching a reference value of 15 % to credit growth, and dampening exchange rate fluctuations. Between May 2013 and January 2014, Turkey's financial markets and the lira were under severe downward pressure as a result of changing international monetary conditions, domestic political tensions and regional turmoil. In this period, the lira depreciated by 15.1 % in real effective terms. Fuelled by the depreciating currency, accelerating food prices, and some indirect tax increases, consumer price inflation increased from 6.2 % year-on-year at the end of 2012 to 7.4 % in December 2013, i.e. clearly above the central bank's target of 5 % and outside the tolerance band of +/- 2 percentage points around the target. Foreign-exchange adjusted credit growth had increased to 25 % by the end of 2013. In mid-2013, the central bank started to move to a less accommodative policy stance and supported the lira by selling foreign exchange reserves. When downward market pressures intensified in December-January, monetary policy was tightened more decisively. Following an extraordinary meeting of its monetary policy committee on 28 January 2014, the central bank raised the overnight lending rate and the one-week repo rate to 12 % and 10 %, respectively, and announced that the tight policy stance would be sustained until the inflation outlook had improved significantly. As part of these decisions, the complex monetary policy framework was simplified somewhat. Subsequently, the downward pressures in Turkey's financial markets subsided and the lira appreciated by 7.4 % in real effective terms between January and August. Credit growth declined to below 20 % year-on-year, helped by macro-prudential measures introduced in October 2013 to rein in consumer borrowing. The inflation performance, however, deteriorated further with headline inflation fluctuating in the 9-10 % range between April and August, core goods inflation running above 10 %, and inflation expectations trending upwards. Nevertheless, the central bank again reversed the course of its monetary policy by lowering the one-week repo rate to 8.25 % in three steps between May and July and the overnight lending rate to 11.25 % in August. ***Overall, inflation has increased noticeably and is now diverging significantly from the central bank's target. The central bank has continued to pursue multiple objectives within an unconventional and complex monetary policy framework that hampers transparency and predictability. A clear focus on the primary objective of price stability is required to attain the central bank's inflation target.***

Regarding public finances, transparency continues to suffer from the lack of timely information in accordance with international standards on the fiscal account for general government. As far as central government is concerned, the 2013 budget deficit was lower than originally planned. The original unambitious deficit target of 2.2 % of GDP was revised to 1.2 % last October which is estimated to have been met. Revenues increased by a higher-than-planned 17.1 % year-on-year, mainly as a result of changes in indirect taxation and social security premiums, privatisation and dividend receipts, and one-off factors like the payment of VAT arrears by state-owned enterprises. Expenditure increased by 12.7 % compared to 2012, clearly above nominal GDP growth (10.2 %) and with some significant budgetary overruns, not least on capital spending. In the first half of 2014, expenditure increased faster than revenue on a year-on-year basis, but the central government's 12-month rolling budget deficit stabilised around 1.5 % of GDP. General

Graph 5.3: **Fiscal developments**



government debt increased by 10.6 % in absolute terms in 2013, partly because the depreciation of the Turkish lira increased the value of the foreign currency debt in domestic currency terms. Consequently, the downwards trend in the debt-to-GDP ratio came to a halt in 2013 and the ratio edged up by 0.1 percentage point to 36.3 % over the year. ***Overall, fiscal performance benefited from a temporary surge in revenues, but continued to show budgetary overruns on the expenditure side. The sustainability of public debt was maintained. There was no progress on increasing the transparency of the fiscal framework. Adopting a fiscal rule would provide a significant fiscal anchor, increase credibility and support the envisaged reduction of the structural fiscal deficit.***

The ongoing dependence on capital inflows is a macroeconomic vulnerability which makes Turkey prone to boom-bust cycles. The tightening of monetary policy in early 2014 helped to halt the lira’s depreciation trend and to reduce the year-on-year credit growth rate (adjusted for exchange rate effects) from 25 % to 21.5 % over the course of the first quarter. In view of the continued overshooting of the inflation target and the chronically low private saving rate, monetary policy should remain tight. Furthermore, fiscal policy should help to increase domestic saving by pursuing a sufficiently restrictive course. ***Overall, the Turkish economy remains vulnerable to bouts of financial uncertainty and changes in global risk sentiment and there is scope for adjusting monetary and fiscal policy to lower the macroeconomic imbalances.***

Interplay of market forces

The proportion of directly administered prices in the Consumer Price Index (CPI) basket has remained below 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 energy (natural gas and electricity), automatic pricing mechanisms are applied in principle which link 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 no progress in eliminating the cross-subsidisation between consumers in the wholesale and retail electricity markets. The private sector proportion of GDP has remained stable at 86.5 %. Privatisation activity, particularly in the electricity sector, was stepped up, with the total volume of completed deals increasing from € 2.3 billion (0.4 % of GDP) in 2012 to € 9.2 billion (1.5 % of GDP) in 2013. Privatisation tenders continued in early 2014, particularly in the energy sector. ***Overall, privatisation has accelerated, but there has been no progress on price liberalisation as the government continues to interfere in the price-setting mechanism in key sectors. Competition could be increased by continued liberalisation of product and services markets.***

Market entry and exit

The number of newly established businesses increased by 1.6 % in 2013 compared with the previous year. Starting a business in Turkey still requires six separate procedures and takes six days on average. The average cost of starting a business has increased to 12.7 % of per capita income from 10.5 % in the preceding year. Obtaining a construction permit is still very cumbersome and time-consuming. The number of businesses closing down or being liquidated fell by 20.6 % compared with 2012. Closing a business remains expensive and time-consuming. Insolvency procedures last an average of 3.3 years and recovery rates — at 22.3 % on average — remain very low and are falling. ***Overall, starting a business has become somewhat more expensive and market entry conditions could generally be improved. Market exit remains costly and long, and insolvency proceedings are still heavy and inefficient.***

Legal system

A reasonably well-functioning legal system has been in place in the area of property rights for several years. Enforcement of commercial contracts is still a rather lengthy process, partly because commercial court judges are insufficiently specialised. The expert witness system still operates as a parallel judicial system, but does not improve overall quality. Out-of-court dispute settlement mechanisms are seldom used, except in the insurance sector, tax and customs. The judicial system and its administrative capacity could be further improved. A proposal for a new amnesty on interest payments related to tax arrears has been submitted to parliament. The recurrent introduction of such amnesties and restructuring mechanisms discriminates against regular payment and harms the tax and social security administrations' collection capacity in the long term. Taxpayers or other citizens subject to fines have a clear advantage in delaying their payments, especially in the current inflationary environment. ***Overall, the legal system continues to function relatively well in the area of property rights, but in general 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 stable (87.4 % in June 2013). The relatively small insurance sector's share (including private pensions) remained unchanged at 4.6 %. The value of banking sector assets increased from 97 % of GDP in 2012 to 111 % in 2013. State-owned banks' share of total banking sector assets remained roughly stable, at close to 28 % in 2013. The state's share in Halkbank, the country's seventh-largest bank by assets, has remained at 51.1 % in 2013 in the absence of a strategy for its further privatisation. Foreign banks' share increased from 12.7 % in 2012 to 13.9 % in 2013.

Following the switch to a more accommodative monetary policy stance in 2012, banks' foreign-exchange adjusted loan portfolio accelerated in 2013 and reached 25 % at the end of the year. Macro-prudential measures in October 2013 and the tightening of monetary policy in January 2014 have gradually lowered credit growth in the first eight months of 2014. The banks' loan-to-deposit ratio increased further and reached 109 % by the end of 2013.

The banking sector has maintained an adequate profitability performance. Net profit increased by 5.1 % in 2013, but was 12.4 % lower year-on-year in the first seven months of 2014. The sector's capital adequacy ratio increased to 16.3 % in May 2014 which is significantly above the regulatory target of 12 %. Basel II standards have been implemented in capital adequacy calculations since July 2012 and the necessary legislation for the implementation of Basel III was mostly completed in 2013. The proportion of non-performing loans in total banking sector loans has remained broadly stable at just below 3 %. ***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

Human and physical capital

According to the OECD's regular assessment of educational performance for 15-year-old students (PISA), the mean score of Turkish students improved in the three categories of science (9 points), mathematics (3 points) and reading (11 points) between 2009 and 2012. The average improvement of 8 points was, however, below the 23 point improvement seen between 2006 and 2009 and Turkey remains 48 points below the OECD average. Schooling ratios have increased at all levels of education between 2011/12 and 2012/13 reaching 99 % for the first four years and 93 % for the second four years of primary school and 70 % for secondary school. However, sizeable gaps persist regarding the schooling ratios for girls, especially in secondary school. Participation in higher education remains low by international standards, although the percentage of the population aged 30-34 with tertiary education qualifications increased from 18 % in 2012 to 19.5 % in 2013. ***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. Deepening and widening of labour market reforms would help to upgrade and make better use of Turkey's human capital.

Total investment remained unchanged at 20.3 % of GDP between 2012 and 2013, but there was a shift from private to public investment. While private investment continued to decline as a proportion of GDP (from 16.4 % to 15.6 %), public investment continued to increase (from 3.9 % to 4.7 %). Gross foreign direct investment (FDI) inflows to Turkey decreased from 1.7 % of GDP to 1.6 % of GDP and the FDI stock as a proportion of GDP fell from 23.6 % to 19.9 % over the year. R&D expenditure (both public and private) edged higher from 0.86 % of GDP (2011) to 0.92 % (2012), far below the government's current target of 1.8 % by 2018. Little progress was made in upgrading the transport infrastructure in 2012: the length of the railway network remained unchanged, the motorway network was only extended slightly, and the total length of other roads increased by 4.2 %. ***Overall, improvements in the country's physical capital have been modest.***

Sectoral and enterprise structure

In 2013, GDP growth of 4 % was achieved with 2.8 % employment growth, indicating rising labour productivity in the overall economy. The sectoral breakdown of employment growth shows a continued shift towards the services sector whose share of total employment went up by 0.7 percentage points to 50.9 %. Industry gained 0.2 percentage points to 20.7 %, construction remained unchanged at 7.2 %, while agriculture lost 0.9 percentage points to 21.2 %. In terms of proportion of GDP, agriculture declined by 0.5 percentage points to 7.2 %.

There has been continued progress in the liberalisation of the network industries. Following the entering into force of a new electricity market law in March 2013, an estimated 85 % of the market has been opened for competition with the aim of achieving 100 % by 2015. The transfer of distribution assets to private companies was completed, but progress in the privatisation of electricity-generating assets remained limited due to difficulties for potential investors in securing necessary financing. Further progress is needed to liberalise the natural gas market by reducing the monopolistic market share of state-owned BOTAŞ. A draft law to amend the Natural Gas Market Law has yet to be adopted by parliament. A transparent and cost-based pricing mechanism for electricity and gas remains to be properly implemented. ***Overall, the liberalisation of the electricity market made significant advances, but there was little progress in other network industries.***

State influence on competitiveness

Legislation to implement the State Aid Law, originally scheduled to be enacted by September 2011, has been postponed until the end of 2014. The State Aid Authority has still not formally set up a comprehensive state aid inventory or adopted an action plan to align all state aid schemes, including the 2012 incentives package, with the *acquis*. Amendments to the legal framework for public procurement (*see Chapter 5 — Public procurement*) brought this further out of line with the EU *acquis*. ***Overall, there has been no progress in improving the transparency of state aid and there has been some backsliding in public procurement.***

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 between 2012 and 2013 from 57.8 % to 58.0 %. The proportion of trade with the EU out of Turkey's total trade increased from 37.8 % to 38.5 %. The EU proportion of Turkey's exports increased from 39.0 % to 41.5 %, while its proportion of Turkey's imports decreased slightly from 37.1 % to 36.7 %. The EU remained the largest source of FDI flows into Turkey although its proportion declined from 67.9 % of the total to 51.8 %. The Turkish lira depreciated by

5.0 % in CPI-based real effective terms between June 2013 and June 2014, which has improved Turkey’s international price competitiveness. ***Overall, trade and economic integration with the EU has remained high and Turkey has gained international price competitiveness from currency depreciation.***

5.3. CONCLUSIONS

As regards the economic criteria, Turkey is considered 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 comprehensive structural reforms.

Following the slowdown in 2012, output and employment have increased at a moderately high rate. Nevertheless, unemployment has risen as a result of a strongly expanding labour force. The current account deficit, while narrowing somewhat in 2014, has remained at an elevated level. The reliance on sustained capital inflows makes Turkey vulnerable to changes in global risk sentiment, resulting in large exchange rate fluctuations.

Although fiscal deficit and public debt have remained at moderate levels, continuing budgetary overruns on the expenditure side call for a strengthening of the fiscal framework. Fiscal policy should help raising overall national saving in view of the need to reduce the external deficit. Considering that inflation has trended upwards, diverging further from the central bank’s target, monetary policy needs to pursue a restrictive course and be focused clearly on price stability. Notwithstanding some progress regarding privatisations and the liberalisation of the electricity market, it is essential that structural reforms are accelerated on a broad basis to improve the functioning of the markets for goods, services and labour. These reforms should include further improvements in the judicial system and of administrative capacity, enhanced transparency of state aids, and an open, fair and competitive public procurement system.

6. BOSNIA AND HERZEGOVINA

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Macroeconomic stability was broadly maintained but the export-led recovery remains fragile. Despite a shrinking current account deficit, external imbalances remain large, reflecting limited output- and export diversification and a generally low degree of competitiveness. A significant state presence in the economy as well as considerable weaknesses in the business environment continue to negatively affect private sector development. No progress has been made towards creating a single economic space within the country. Some measures to improve public finances sustainability have been adopted in both Entities but the quality of public finances remains low and fiscal discipline and expenditure control have to be strengthened. The stalled privatisation process and the unfavourable composition of public expenditures continue to significantly undermine the growth potential of the economy. Unemployment remains persistently high.

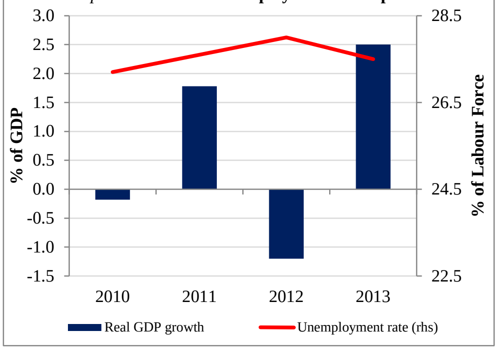
Economic policy

Consensus between the authorities at different government levels led to an agreement on a medium-term countrywide fiscal strategy -the Global Frameworks on Fiscal Balance and Policies for 2014-2016 and 2015-2017- were adopted, albeit with some delay. Consensus was also reached regarding some adjustments in excises along with several reform steps aimed to improve fiscal sustainability. However, significant efforts are still needed to develop further the medium-term fiscal strategy in order to strengthen its role as a fiscal coordination tool. In January 2014, the authorities submitted their Economic and Fiscal Programme (EFP) for 2014-2016. It foresees a gradual economic recovery based on strengthening of domestic demand, but at the same time remains silent on pressing structural reforms, in particular beyond 2014, and faces non-negligible implementation risks. A nine-month extension of the Stand-By Arrangement (SBA) with the IMF, totalling € 153.6 million was granted in January 2014. Following a temporary stalemate in early 2014, the combined sixth and seventh review of the SBA was completed in June 2014. To meet the country's urgent balance of payments needs caused by the severe flooding in May 2014, the programme was at the same time augmented by about € 95.7 million. Budgetary support from the World Bank, which had already been delayed and temporarily suspended, is expected to be disbursed by the end of 2014. The country needs to step up its efforts on fiscal consolidation and improving public spending composition and targeting, address the high burden of non-performing loans in the banking sector, improve the business environment, and reduce labour market rigidities, in line with targeted policy guidance as outlined by the European Commission in the framework of the EFP dialogue in June 2014. ***Overall, despite some slight improvement, the consensus on economic and fiscal policy essentials remained weak and significant efforts are needed to pursue reforms already envisaged***.

Macroeconomic stability

The economy recovered somewhat in 2013 but this recovery is fragile. Output growth reached 2.5 % in 2013 and accelerated to 2.7 % in the first quarter of 2014, compared to a drop by 1.2 % in 2012. *Per capita* GDP in purchasing power standards remained at 29 % of the EU-28 average in 2013. Net exports were the main drivers of economic growth, a result of declining imports coupled with buoyant export activity. Despite a modest growth of real wages and broadly unchanged remittances, domestic demand in 2013 was held back by a stagnating private consumption on the back of a slowing credit growth

Graph 6.1: **GDP and unemployment developments**

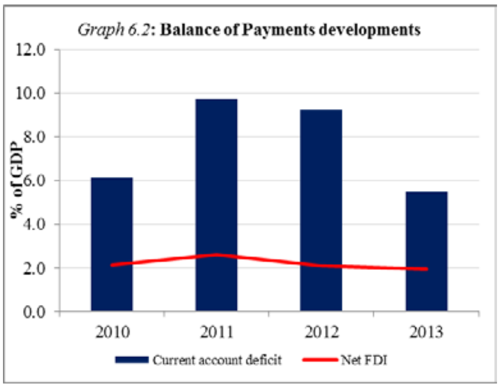


and persistently high unemployment. At the same time, investment activity posted a meagre growth thanks to foreign-financed public investments, while private investments were stagnant. Signs of fragility are becoming evident in 2014. Partly due to base effects export growth came to a halt in the first five months in 2014 but showed signs of modest recovery afterwards, while imports reversed their negative trend. Heavy floods in the spring severely damaged transport- and energy infrastructure as well as production and are expected to result in a drag on short-term GDP growth. ***Overall, the economy is slowly emerging from recession but economic growth remains fragile and the short-term outlook has deteriorated due to the spring floods.***

Table 6.1:
Bosnia and Herzegovina - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	-2.7	0.8	1.0	-1.2	2.5	0.4
Private consumption	Ann. % ch	1.8	0.9	1.6	2.2	2.9	N.A.
Gross fixed capital formation	Ann. % ch	-16.8	-12.2	7.9	5.2	-2.6	N.A.
Unemployment (LFS) rate	%	24.1	27.2	27.6	28.0	27.5	27.5
Employment	Ann. % ch	-2.8	1.9	-1.6	-0.4	0.6	2.2
Wages	Ann. % ch	8.2	1.1	4.4	1.5	0.1	0.2
Current account balance***	% of GDP	-6.5	-6.1	-9.7	-9.3	-5.5	-6.7
Direct investment (FDI, net)***	% of GDP	1.4	2.1	2.6	2.1	1.9	1.5
CPI, average	Ann. % ch	-0.4	2.1	3.7	2.0	-0.1	-1.6
Exchange rate BAM/EUR	Value	1.96	1.96	1.96	1.96	1.96	1.96
General government balance	% of GDP	-4.4	-2.5	-1.3	-2.0	-2.2	0.6
General government debt	% of GDP	N.A.	39.3	40.5	45.1	46.2	28.7**

* Q1 ** Refers only to foreign public debt. *** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat

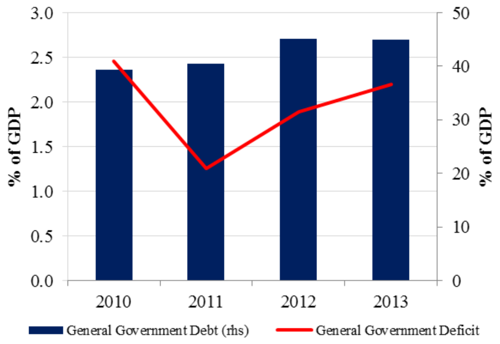


External imbalances narrowed substantially in 2013 on the back of stagnating private consumption and imports coupled with a solid export performance, but started to widen again in the first half of 2014. The current account deficit nearly halved to 5.5 % of GDP in 2013 from well above 9 % of GDP in the previous two years, mainly linked to a strong improvement of the trade deficit to 30.5 % of GDP from 33.6 % of GDP in 2012. At the same time, the contribution of current transfers, although slightly declining from last year, amounted to some 10 % of GDP. The trend for a narrowing trade deficit reversed in the first seven months of 2014 when merchandise exports expanded at a slower pace (1 % in annual terms), while imports of goods picked up by some 6 %. The current account deficit increased to 6.1 % of GDP in the four quarters to March 2014. Net foreign direct investment (FDI) inflows, which accounted for only one-third of the current account deficit financing, continued their declining trend and amounted to a meagre 1.9 % of GDP in 2013 even narrowing further in the first quarter of 2014. Net foreign exchange reserves steadily increased in the course of 2013 and the first half of 2014 and covered more than five months' worth of imports, boosted partly by financial assistance under the IMF Stand-By Arrangement. ***Overall, the external imbalances have narrowed but remain a source of vulnerability, especially in view of the potential adverse impact of the volatile environment on FDI inflows.***

Labour market conditions improved somewhat during 2013 despite continuous adverse developments in some sectors (e.g. construction). Notwithstanding a slight rise of employment in the manufacturing sector, the public sector still accounts for the largest share in the workforce (27 %) in 2013. The unemployment rate (ILO methodology) dropped by half a percentage point to 27.5 % of the workforce in 2013 and remained unchanged in 2014. At the same time, the already low employment and activity rates of the population aged 15 years and older also slightly declined further to 31.6 % and 43.6 %, respectively. The structural nature of unemployment is reflected by the high share of long-term unemployment accounting for around four fifths of total job-seekers, while youth unemployment remains close to 60 %. A significant difference between the registered and survey-based labour figures points towards the existence of a fairly large informal labour market. ***Overall, labour market conditions have remained difficult and structural rigidities continued to hamper job creation, including for youth, calling for urgent measures to reduce disincentives to hiring, enhance flexibility of the labour market, and increase participation rates.***

Inflationary pressures abated in the course of 2013 bringing consumer price inflation from 2 % in 2012 down to -0.2 % in 2013. The deflationary trend started in August 2013 and continued in the first half of 2014. Consumer prices declined by 1.4 % in the period January-July 2014. Monetary policy of the central bank continued to be conducted under a currency board arrangement—with the euro as anchor currency—enjoying a high level of confidence and credibility. ***Overall, the currency board has continued to function well, but feeble domestic demand and persistent deflation are growing causes for concern.***

Graph 6.3: **Fiscal developments**



Despite some fiscal consolidation measures in 2013 such as the freeze of public sector wages and restrictive employment policy in both Entities and the central government, as well as additional measures including the one-off cut of salaries in Republika Srpska, the general government deficit remained broadly unchanged at 2.2 % of GDP. In particular, public expenditures in 2013 declined by 1 percentage point to 45.6 % of GDP and are heavily biased towards current expenditures. The public wage bill still accounts for a large share of expenditures although marginally decreasing to 12.5 % of GDP, while expenditures on social benefits remained unchanged at some 17 % of GDP. At the same time, capital expenditures increased slightly to 6.8 % of GDP. Expenditure consolidation was coupled with some underperformance of revenues dropping to 43.4 % of GDP in 2013 partly due to the decline of net indirect taxes, in particular because of high VAT refunds. In the first half of 2014, the fiscal situation deteriorated again as a result of the spring floods and the temporary stalemate of the Stand-By Arrangement with the IMF against the backdrop of elevated debt servicing needs in 2014, thus prompting a rebalancing of the Entities' budgets. In particular, the emergency financing needs to tackle the consequences of the spring floods are likely to double the target of the consolidated fiscal deficit for 2014 to close to 3 % of GDP. ***Overall, the fiscal situation improved slightly in 2013 but worsened again in early 2014 amid a persistently low quality of public finances. Further efforts are needed to address the composition of public spending***.

The management of public finances appears to have strengthened in 2013-2014 with the adoption in due time of the State and Entity budgets, although the Global Frameworks for Fiscal Policies 2014-2016 and 2015-2017 were adopted with some delay. To improve the long-term sustainability of the Entity's public finances, in September 2013 the Federation government endorsed a strategy for a contributory pension system reform. A new Law on Budgets in the Federation entered in force in January 2014 aiming to enhance the coordination with lower levels of government i.e. Cantons and municipalities. However, the quality of fiscal reporting remains low, undermining public scrutiny, proper analysis and policy design. ***Overall, important steps towards improving the sustainability of***

fiscal policy have been taken, but significant further efforts are required, notably with a view to strengthening expenditure controls and fiscal discipline.

General government debt (domestic and external), although still below the statutory ceilings of the Entities, has been steadily increasing in recent years to reach 46.2 % of GDP in 2013 according to national data. This was mainly due to an increase of external borrowing reaching 28.2 % of GDP at end-2013, however, with an average favourable interest rate of 1.44 %. At the same time, both Entities issued short-term treasury bills and long-term government bonds in 2013 securing relatively favourable conditions due to high demand. The issuance of government securities intensified in the first half of 2014 linked to the temporary stalemate of the programme with the IMF and elevated refinancing needs estimated to increase to 4.5 % of GDP in 2014. In addition, the spring flooding is putting further pressure on public finances. ***Overall, despite a still moderate level, the upward trend of public debt and the elevated servicing needs are a source of macro-financial vulnerability***.

Interplay of market forces

The share of the private sector continues to account for about 60 % of GDP while the government's influence over economic activity has remained significant as reflected in the share of GDP of public expenditures and the off-budget expenditures for state-owned firms. Despite the adoption of privatisation strategies in 2013 and 2014, the privatisation process in the Federation continued to suffer setbacks. The unsuccessful attempts to sell 11 companies in 2013, mostly with minority stakes of the state, left the initial stock of state-owned capital for privatisation unchanged at some two-thirds. In Republika Srpska, about 2/3 of the enterprises intended for privatisation had been sold prior to the crisis, while other companies previously offered for sale were forced to declare bankruptcy. Most prices are liberalised and a number of regulated prices remain (e.g. utilities). ***Overall, the long-stalled privatisation process needs to be re-started again.***

Market entry and exit

In spite of some recent improvement, the business registration and start-up process remains cumbersome and costly. The lack of harmonisation of registration procedures across Entities still requires entrepreneurs to register in both Entities before they can do business in the whole country. The implementation of the ambitious business environment reform in Republika Srpska continued in 2013 and early 2014 with the establishment of one-stop-shops for business registration as of December 2013, the reduction of the number of required procedures (from 11 to 5) and of business start-up costs (from € 500-750 to € 200). In the Federation, the adoption of amendments to the Law on Business Registration as well as the Law on Companies and Inspections also aimed to simplify and shorten business registration. Despite the acceleration in economic activity in 2013, the number of newly registered companies decreased significantly by 14.1 % from a year earlier. Slow contract enforcement, limited access to financing and political instability remained key disruptive factors for doing business in the country. No progress was made in easing market exit or bankruptcy procedures. ***Overall, the simplification of business registration has continued, albeit slowly, but significant administrative barriers for private-sector development still remain.***

The legal system

No substantial improvements can be reported as regards the business legal system in Bosnia and Herzegovina, which remains complex and challenging. The implementation of laws is often poor due to weak institutional enforcement capacity. The judicial system still frequently does not function efficiently and in particular struggles to cope with commercial dispute settlements. The enforcement of commercial contracts remains a lengthy process, which involves 37 procedures and still takes an average of 595 days. A weak rule of law and unreliable contract enforcement procedures continue to hamper the business environment. ***Overall, lengthy contract enforcement 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 in 2013, accounting for 84.6 % of all financial system assets and some 84 % of GDP. The number of banks operating in the country at end-2013 decreased to twenty-seven following revocation of one bank licence in June 2013. The banking sector remains highly concentrated and is dominated by foreign capital holding slightly below 90 % of total banking assets. There are only two majority state-owned banks while the rest are privately-owned.

The banking system remained well capitalised and liquid in 2013 and in the first quarter of 2014. The capital adequacy ratio decreased slightly to 17.3 % in the second quarter of 2014 compared to 17.8 % as of end-2013. In 2013 the maximum coverage level within the deposit guarantee scheme was increased to € 25000 from previously € 18000, with twenty-six banks participating. The liquidity of the system improved and the ratio of liquid assets to total assets as of end December 2013 rose slightly to 26.4 %. However, financial stability pressures have somewhat increased. Banking sector profitability ratios continued their downward trend and turned temporarily negative as of end 2013. Moreover, banks’ exposure to credit risk has increased as the ratio of non-performing loans (NPLs) rose to 15.5 % of total loans in the second quarter of 2014 compared to 14.3 % a year earlier, with a further increase likely to result from the spring flooding. So far, the deterioration has been mitigated by an increase in loan loss provisioning.

Although credit growth remained positive, it decreased substantially to 2.8 % in 2013, mainly on the back of a deceleration of corporate lending. However, there were signs of recovery of corporate lending in the first half of 2014. At the same time, retail lending increased substantially throughout the period and rose on annual basis by 6.5 % in June 2014. The magnitude of potential crowding out of private investment by the public sector is likely to be limited given the relatively low share of the government sector in total credits. The importance of deposits as a source of bank financing continued to increase with deposit growth accelerating to 7.8 % in June 2014 after a growth of 6.9 % in 2013. The trend of stronger deposit growth in the corporate sector started in mid-2013 and continued through the first half of 2014, swelling by 12.7 % on average, while households increased their savings by 8.8 %. However, on the back of the acceleration in credit growth, the loans-to-deposits ratio slightly rose to 116 % in June 2014. ***Overall, the banking system remains well capitalised and liquid. However, the increasing share of non-performing loans is a cause for concern.***

The capital market in Bosnia and Herzegovina remains small and the turnover concentrates on a few privatised companies and government financing instruments. The combined stock market capitalisation increased marginally to 34 % of GDP largely due to government bonds and bills that account for around 75 % of total market capitalisation. In 2013, twenty-five companies were operating in the insurance sector in the country. ***Overall, financial intermediation by the non-banking sector remained shallow***.

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

Human and physical capital

Information and statistics on human capital remain scattered. The overall progress in the area of education continues to be very limited, despite the increase of gross enrolment rates for higher education. The educational reform agreed in 2012 remains ineffective, though some progress has been made in the area of accreditation of higher education institutions. The significant number of unemployed with university degrees possibly reflects inefficiencies in the higher education system. Unemployment among youth (age group 15-24) stands at close to 60 % and is the worst among all age groups. However, necessary reforms of the labour legislation to decrease labour market rigidities are still pending, while labour market programmes in place do not effectively address long-term and youth unemployment. ***Overall, significant efforts are needed to improve the quality and efficiency of the education system and support a proper functioning of the labour market.***

The unfavourable business environment coupled with low shares of public capital expenditures in recent years put a drag on the improvement of physical infrastructure. The floods in May 2014 have impaired large parts of the country's infrastructure and the reconstruction needs completely overstrains the thin public capital budget. However, the investment-to-GDP ratio in 2013, which remained broadly unchanged at the relatively modest level of 17.8 % of GDP, is likely to increase in view of international aid-supported reconstructions following the floods. Due to the stalled privatisation process and unsupportive business environment, net FDI flows in 2013 continued their downward trend reaching 1.9 % of GDP, targeting the energy sector and infrastructure projects. Investments in the energy sector were directed mainly towards hydro and coal-burned power plants, while investments in infrastructure were mainly driven by construction works on the highway of Pan-European Corridor Vc but with slow progress. In total, inward FDI stock reached € 5.9 bn or 44 % of GDP by end-2013. ***Overall, there is a need to rebuild fiscal space for growth-enhancing public investments and to enhance the business environment to attract private investment, in particular FDI, both of which are crucial for improving the underdeveloped infrastructure which was furthermore damaged by the floods.***

Sector and enterprise structure

Limited progress has been achieved in unbundling electricity networks as well as towards a competitive telecommunications market. The three incumbent operators continue to act in their geographical areas as *de facto* monopolies over fixed voice telephony. The number of new registrations in the internet services and network operators market continued its upward trend in 2013. The penetration rate of internet users reached 65.4 % at the end of 2013, while the rate of broadband internet access increased marginally to a still relatively low level of 13.5 %. ***Overall, limited progress was achieved on the liberalisation of network industries***.

According to the Statistical Business Register from end-June 2014 only 56.7 % of enterprises are active. The majority (75.1 %) are micro-enterprises with less than 10 employees operating mainly in the wholesale and retail sale sector. The economy continues to be dominated by the services sector, which accounted for around 62 % of gross value added (GVA) in 2013, followed by industry (20 %) and agriculture (8.1 %). The contribution of the construction sector to GVA contracted further to 4.6 %, while the traditionally high share of public administration, education and health protection remained broadly unchanged at 18.8 %. The informal sector fuelled by poor law enforcement and the inadequate fight against corruption represents a major obstacle for industry development and imposes significant risks and costs on the overall economy. ***Overall, there have been no major changes in the structure of the economy and the need to address the informal sector remains.***

State influence on competitiveness

No major progress has been made in reducing the state's influence on the economy. In addition, hardly any measures to decrease para-fiscal charges have been implemented, thus putting an additional brake on private sector development. Direct budget subsidies to industry and agriculture at consolidated level decreased to around 1 % of GDP in 2013 partly due to consolidation efforts during the year. Similarly to previous years, the Entity governments provided loan guarantees worth 6.3 % of GDP to several companies in the infrastructure sectors. The State aid authority remains to become fully operational and its financing issue is yet to be resolved. Bosnia and Herzegovina still needs to improve the consolidated state aid inventory reporting and address the issue of transparency of all directly granted state aid. ***Overall, state aid remains significant and the state-owned monopolies are an enduring drain on public resources.***

Economic integration with the EU

The openness of the economy measured as the sum of total imports and exports of goods and services marginally fell to 80 % of GDP in 2013 as compared to 81 % in 2012, mainly on account of shrinking imports even though exports slightly increased to 30 % of GDP. The overall coverage of import by export increased to 58.7 % up from 54.5 % in 2012. The EU remains Bosnia and Herzegovina's main trading partner, increasing its weight further with Croatia's EU accession as of 1 July 2013. Accordingly, the share of exports to the EU increased to 73.5 %, while imports from the EU came slightly down to 60 % of total imports. The most important EU trade partners are Germany and Croatia, although the pending adoption of quality standards required by the accession of Croatia to the EU puts downward pressure on the share of both Croatian imports and exports. CEFTA countries remained the second single most important trading partner and accounted for some 16 % of merchandise exports and 11 % of imports of goods. ***Overall, the already high level of trade integration with the EU remained broadly unchanged***.

6.3. CONCLUSIONS

As regards the economic criteria, Bosnia and Herzegovina has made little progress towards becoming a functioning market economy. Considerable steps would be needed to tackle persistent structural weaknesses to be able to cope with competitive pressures and market forces within the Union over the long term.

Economic growth has modestly resumed and the current account deficit has narrowed amid persisting external imbalances. The recovery remains fragile due to weak domestic demand and a narrow production base. The heavy flooding in the spring is expected to worsen the short-term economic and fiscal situation. Efforts have been made to improve fiscal coordination in the Federation as well as the collection of indirect taxes.

Bosnia and Herzegovina should pursue further urgent measures to preserve fiscal discipline. In addition, efforts are required to address the significant state presence in the economy and to reduce the level and improve the composition and the targeting of public spending. Moreover, the inefficiency of public enterprises should also be adequately tackled. Better coordination between and within the entities would significantly facilitate and improve economic policy making. High labour market imbalances as reflected by the persistently high unemployment, notably among the youth, as well as the very low participation rate, call for decisive steps to remove disincentives to work and to improve the quality of education. Deficiencies in the legal and business environment, notably lengthy contract enforcement and costly and complex procedures of business entry and exit as well as the underdeveloped infrastructure should be addressed to support private-sector development and attract investment, especially foreign investment. In this context, the informal sector also remains an important challenge. In addition, the high level of non-performing loans needs to be tackled.

7. KOSOVO*

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

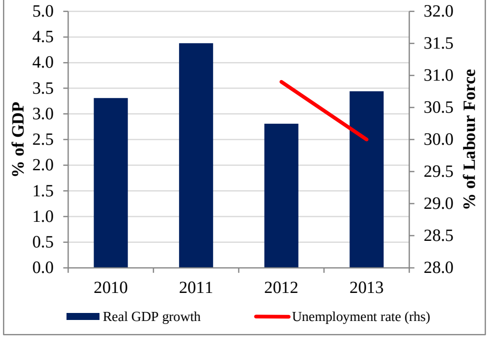
Although Kosovo's economy grew uninterruptedly since 2001 much of its growth can be attributed to the low base effects as genuine sources of sustainable growth remain absent. High and persistent external imbalances, somewhat mitigated by significant inflow of worker remittances, showcase a weak production base and lack of international competitiveness. Inefficient and heavily subsidised POEs, and ad hoc decision making, characterise Kosovo's public sector. Although measures such as the introduction of the fiscal rule were enacted, their reinforcement mechanisms remain weak. The labour market is characterised by low participation and high unemployment rates. Large shares of youth, long term and unskilled unemployed show deeply embedded structural rigidities. The widespread informal economy, weak rule of law and lack of fiscal predictability remain major obstacles to doing business and improving competition and productivity in the economy. Significant further efforts are needed to develop a competitive private sector and anchor fiscal sustainability**.**

Economic policy

Consensus on the essentials of key economic policies was broadly maintained, though dissent between the ruling coalition and the opposition on the privatisation process of Post and Telecom of Kosovo (PTK) led to a two-month deadlock in the assembly and also delayed the adoption of the 2014 government budget. Efforts to develop relations with international financial institutions were sustained. The European Investment Bank re-launched its operations in the second half of 2013 and Kosovo became a member of the Council of Europe Development Bank in November 2013. A 20-month precautionary IMF standby arrangement (SBA) was successfully concluded in December 2013. The 2014 budget plan was the first that complied with a fiscal rule. However, the government's pre-election decision in March 2014 to increase salaries, pensions and other benefits to levels significantly higher than envisaged in the initial budget altered the structure of expenditure at the expense of growth-enhancing capital spending and raised questions regarding the transparency and credibility of fiscal policy. ***Overall, the pursuit of market-oriented economic policies slowed and the predictability of economic policies weakened as a result of ad hoc approaches in policymaking.***

Macroeconomic stability

Graph 7.1: **GDP and unemployment developments**



Economic growth rebounded in 2013 to 3.4 % from 2.8 % in 2012, driven by private consumption and a marginal improvement in net exports, with a negligible contribution from investments. Due to better economic performance of the main diaspora countries higher remittances underpinned private consumption. The positive net exports contribution was influenced by subdued domestic demand rather than an improvement in international competitiveness, as imports contracted substantially. A narrow and internationally uncompetitive production base, deficient infrastructure, particularly in the energy sector, discouraging business environment and significant skill gaps in the labour market impeded job creation, despite continuous positive growth. GDP per capita([2]) reached € 2 800 in 2013, equal to 11 % of the EU-28 average. ***Overall, Kosovo's economic growth accelerated, but long term sustainable sources of growth are lacking.***

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* This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

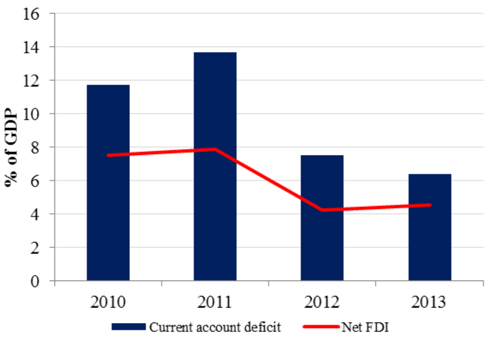
([2]) A measure using purchasing power standards is not available for Kosovo.

Table 7.1:
Kosovo - Main economic trends

		2009	2010	2011	2012	2013	2014 H1
Gross domestic product	Ann. % ch	3.6	3.3	4.4	2.8	3.4	N.A.
Private consumption	Ann. % ch	2.3	3.5	3.5	2.9	2.0	N.A.
Investment	Ann. % ch	10.9	10.9	7.9	-12.9	-0.3	N.A.
Unemployment rate	%	45.4	N.A.	44.8	30.9	30.0	N.A.
Employment	Ann. % ch	8.7	N.A.	N.A.	N.A.	3.8	N.A.
Wages	Ann. % ch	-13.6	-13.1	-1.3	-3.0	-5.5	N.A.
Current account balance**	% of GDP	-9.2	-11.7	-13.7	-7.5	-6.4	-6.5
Direct investment (FDI, net)**	% of GDP	6.9	7.5	7.9	4.2	4.5	2.6
CPI, average	Ann. % ch	-2.4	3.5	7.3	2.5	1.8	0.3
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
General government balance	% of GDP	-0.7	-2.6	-1.7	-2.6	N.A.	N.A.
General government debt	% of GDP	N.A.	5.9	5.3	8.1	8.9	9.6

** refers to a 4 quarters moving average.
Sources: Data Insight, Eurostat, Local authorities

Graph 7.2: **Balance of Payments developments**



External accounts improved in 2013, but remained heavily imbalanced. The current account deficit narrowed to 6.4 % of GDP, 1.1 percentage points lower than in 2012. The trade deficit was brought down to 31.6 % of GDP (2.5 percentage points lower than in 2012) as a result of contracting imports due to weak domestic demand, lower energy prices and somewhat rising goods exports. Concerns that the narrowing of the trade deficit was only temporary rather than of structural nature were reinforced in 2014 as goods exports decreased 0.4 % and imports inched up 1.2 % thus increasing the trade deficit by1.4 % in the first seven months of the year.

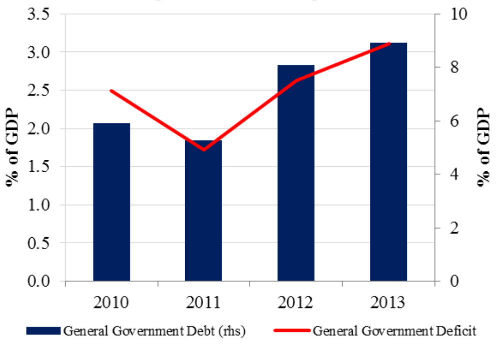
Worker remittances rose by 6.4 % and together with higher current transfers to the non-government sector helped narrow the current account deficit. Financing of the current account deficit depended primarily on net foreign direct investment, which reached 4.5 % of GDP, up from 4.2 % of GDP in 2012. Economic uncertainty, credit tightening, and an increase in investment abroad led to a net outflow of portfolio and other investments of 2.9 % of GDP compared to the inflow of 3.6 % of GDP in 2012. Net errors and omissions, although notably improved (1.3 percentage points lower than in 2012), stood at 3.4 % of GDP still covering a substantial part of the total current account deficit. ***Overall, despite improvements in the trade deficit, significant imbalances persisted, largely due to a weak production base.***

According to the 2013 labour force survey, the labour participation rate among the working age population somewhat increased but still remains unacceptably low at 40.5 %, indicating limited employment opportunities, together with low human capital endowment. Unemployment decreased slightly to 30 %, but remained highest in Europe. The total number of registered job seekers however rose by 3.1 % in 2013 and further 1.5 % by June 2014. The share of unskilled workers among the total unemployed (57.2 % in June 2014), showcases an urgent need for more active labour market policies, prequalification schemes and vocational trainings. In December 2013, the law on the Employment Agency (whose main task is defined as implementing employment and vocational training policies) was adopted. However, no budget allocation was made for the agency for 2014. Statistics regarding the labour market remained inadequate and outdated, hampering a sound analysis of the situation. ***Overall, there have been limited efforts to improve labour market conditions. More efforts and funding should be made to support active labour market policies, which remained insufficient, and to produce adequate data on employment.***

The scope of monetary policy tools is limited, as Kosovo uses the euro as legal tender without access to European Central Bank facilities. The total assets of the financial system, (excluding Central Bank of Kosovo assets) expanded by 10.5 % and reached 83 % of GDP in 2013 from 78 % a year earlier. Due to a decline in demand and tighter bank standards, credit growth slowed down further to 2.4 % by the end of 2013 from 3.8 % a year earlier. Deposits growth continued at a rate of 8.3 %. The loans to deposits ratio decreased from 77.4 % in 2012 to 73.7 % in 2013 pointing to significant scope for deeper financial intermediation and abundance of liquidity in the banking sector. Both loan and deposit average interest rates declined throughout 2013 and 2014, reaching 10.8 % and 0.7 % respectively in July 2014.

The annual average rate of inflation continued to moderate to 1.8 % in 2013, owing to stagnant international food and energy prices. Core inflation (non-food, non-energy) remained unchanged at 1.2 %. The disinflationary trend continued in 2014, bringing down the annual rate of inflation to 1 % by the August.

Graph 7.3: **Fiscal developments**



Although fiscal performance deteriorated in 2013, compared to 2012, the budget deficit remained below the initial plan and stood at 3.1 % of GDP. Total revenues declined by 0.7 %, as border tax revenues contracted, due to lower volume of imports, and underperforming other own sources of revenue (administrative taxes, fines and penalties, participation fees, licences etc.) Total expenditure increased by 1.6 %, as spending cuts mostly at the expense of non-highway capital outlays offset the effect of rising current expenditure. As a result, non-highway capital spending stayed almost 25 % below its projected level. Capital expenditure decreased to 9.9 % of GDP from 10.9 % of GDP in 2012. To finance part of the deficit, and to take advantage of excess liquidity in the banking sector, the government continued issuing domestic treasury bills with progressively longer maturities. In March 2013 a two year maturity bond was issued for the first time. Thus, the total public debt (domestic and external) ratio increased by 0.8 percentage points to 8.9 % of GDP at the end of 2013 according to national data. As the PTK privatisation did not materialise, effectively stripping the government of an estimated 277 million EUR, the budget deficit was partly financed through the withdrawal of government deposits, which were reduced to 2.9 % of GDP, their lowest level since 2008, and well below the 4.5 % of GDP threshold implied by the fiscal rule.

The 2014 budget was to be the first one anchored by the new fiscal rule limiting the total deficit to 2 % of GDP. However, in March, the government adopted a decision to increase salaries of all civil servants as well as social pensions by 25 % (and for retired Trepça miners by 50 %) followed by spending initiatives for former political prisoners and war veterans. These increases in salaries and pensions, significantly higher than envisaged in the adopted budget, are to be funded by wage contingencies, cuts in goods and services expenditures, and by reassigning funds earmarked for civil service reform. As the financing of these initiatives relies to a significant extent on one-off effects, at the expense of delaying important reforms, it raises concerns over the accumulation of government arrears and rising government deficits in the future. These measures could also hurt Kosovo’s price competitiveness by pushing up economy-wide labour costs.

Overall, macroeconomic and fiscal stability was preserved in 2013, but the unbalanced pattern of public sector wage policies with large ad hoc hikes typically occurring in election years severely deteriorates the transparency, predictability and credibility of fiscal policy, complicates fiscal planning and shifts the composition of spending towards less growth-friendly expenditure. The fiscal rule should be strengthened with stricter enforcement mechanisms to avoid a repetition of pre-electoral spending excesses in the future.

Interplay of market forces

The private sector's share in GDP has remained unchanged at an estimated 70 % in 2013. Amidst criticisms of corruption and lack of transparency in the sale of Socially Owned Enterprises (SOE) assets, the Privatisation Agency of Kosovo (PAK) continues to implement its mandate in expediting the sale and liquidation of SOEs under its administration. In 2013 PAK finalised only two liquidation processes and another six liquidation processes in 2014 (as of March). Following one failed attempt, and several delays in 2013, privatisation of the PTK was called off in December 2013, amid numerous corruption allegations and growing opposition by some opposition parties and the civil society. Furthermore, PAK's ability to operate efficiently and in accordance with its mandate was brought into question, when by August 2014, a series of board member resignations and mandate terminations, which were not adequately addressed by the Assembly of Kosovo, resulted in the lack of a board quorum.

Among centrally managed enterprises, only Kosovo Energy Corporation and PTK continued to operate with a profit in 2013. Subsidies to Publicly Owned Enterprises (POEs) in the field of energy imports, central heating, transportation and water amounted to 0.5 % of GDP, a decrease of 0.25 percentage points compared to 2012. The government control and regulation of the electricity, central heating, water supply and waste, and post-telecommunications services prices, via independent agencies, remained unchanged.

Overall, very limited progress has been achieved in privatisation and liquidation of enterprises in PAK's portfolio. The failure of the PTK privatisation and legal uncertainty surrounding PAK raise concerns regarding the future and transparency of the privatisation agenda. Some marginal improvements are exemplified by the reduction of subsidies to POEs.

Market entry and exit

Regulations adopted in 2013, and the establishment of one-stop shops, have reduced the time needed for company registration, to one day for individual businesses, and to three days for limited liability companies and joint stock companies. Kosovo would benefit from addressing numerous other obstacles to private sector development, such as weak administrative capacity, lack of access to finance, underdeveloped infrastructure especially in electricity supply, deficient rule of law, widespread informal economy and inadequate professional education. During 2013, the number of newly registered businesses declined by 1.8 % to 9 421 while the number of exits rose by 28 % to 1 508 compared to the previous year. The total number of active registered businesses stood at 68 309 in September 2014. ***Overall, amid some progress in simplifying business registration, private sector development remains hampered by numerous obstacles.***

Legal system

The basic legal framework on the purchase of real estate by foreigners is compliant with EU rules. However, further efforts are required to review the civil code, and administrative practices are still an obstacle to equal treatment. Regarding the implementation of agreements in the framework of the Pristina-Belgrade Dialogue, all certified copies of civil registry books located in Serbia were handed over to Kosovo. Legislation required to implement the agreement on cadastre still needs to be adopted. While expropriation procedures are applied in a broadly satisfactory manner, the authorities do not carry out proper consultation with displaced property owners. The judiciary system has continued to suffer from poor accessibility, inefficiency, delays and growing backlog of unresolved cases. ***Overall, despite some progress made in civil registry and cadastral records, the judiciary framework, and notably its implementation, remains underdeveloped. Ensuring a properly functioning judiciary system remains an important task. Weak institutional capacity for legal enforcement, delays in courts and prevalent corruption have continued to hinder the business environment.***

Financial sector development

The financial system of Kosovo is dominated by the banking sector, which holds 72.3 % of the total financial sector assets. The faster pace of small bank assets growth contributed to declining degree of the sector's concentration. The banking sector liquidity and capital buffers were further strengthened and remain well above their minimum regulatory requirements. On the other hand, the ratio of non-performing loans to total loans increased to 8.2 % by July 2014, compared to 7.5 % at the end of 2012. The increase was partially due to the slowdown of credit growth and relatively subdued growth in the last two years, which in turn affected the capacity of borrowers to repay loans. The announced introduction of SWIFT and IBAN codes for all bank accounts in Kosovo banks, in 2015, should enable easier and safer money transfers, full transparency and a more efficient fight against money laundering. ***Overall, the tightening of credit standards, together with foreign banks' policies towards increasing parent banks' capitalisation ratios and the decline in demand for enterprise loans decelerated total credit activity, and contributed to preserving good liquidity positions despite the increase in the non-performing loans ratio.***

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

Human and physical capital

Very limited progress has been made in improving the quality of the education sector. Total public spending on education decreased slightly, by 0.1 percentage points, to 3.8 % of GDP in 2013, still less than the average for low and middle income countries (4.3 %). Attempts to address the evident skills mismatch in the labour market were made when a legal framework for the establishment of the Agency for Vocational Education and Training and Adult Education was put in place. However the agency itself is not yet operational. An action plan and a framework for quality assurance have been developed to monitor the quality and performance of vocational education and training schools. Moreover, the National Qualifications Authority, an independent public regulatory institution responsible for monitoring the training and assessment institutes, has established procedures for validation and accreditation. ***Overall, insufficient funding, the low level of cooperation between vocational schools and enterprises to conduct practical learning and delays in the implementation of policies to provide the skills required by the labour market remain as the major problems.***

In 2013, total investment declined and stood at 27.6 % of GDP (down from 29 % of GDP in 2012) with the private share increasing as the government contracted its non-highway related investments. The construction of a highway to Tirana has been completed and the preparatory works for the new highway to Skopje have started in July 2014. Investments in the transmission and distribution networks have improved network stability and reduced technical losses. Power cuts have become less frequent, but an explosion at the highly polluting Kosovo A thermo power plant in June 2014 led to a temporary shutdown of its operations causing additional uncertainty in electricity supply. Nearly half of all incoming foreign direct investment went to the non-tradable sector, in particular real estate and construction, while the share of FDI channelled to manufacturing declined to only 7 % (from 14 % in

2012). There was no greenfield investment. ***Overall, there has been very limited progress in the improvement of physical capital besides road infrastructure. Higher priority should be given to sectors such as education, energy efficiency and water distribution. FDI inflows, by large degree, seem to be financing consumption rather than investment which could spell balance of payments problems in the future.***

Sectoral and enterprise structure

Kosovo's private sector seems to be fragmented and unable to benefit from efficiency gains brought by exploring economies of scale as SMEs with fewer than 250 employees account for 97 % of total employment. Wholesale and retail trade continues to be the dominant sector, with a share of 30.3 % of all new enterprises, followed by the service sector and real estate, with approximately 20 %. The large informal sector fuelled by weaknesses in both tax policies and law enforcement continues to hinder fair competition and to harm the business environment. It also hinders improvements in productivity by constraining entrepreneurs' access to capital, broader markets and technologies. ***Overall, Kosovo's private sector remains underdeveloped. The large informal economy, low access to finance and its high cost continue to pose major challenges. Reducing the share of the informal economy remains a challenge.***

State influence on competitiveness

The government has extended the grant scheme consisting of coupled payments in agriculture sector. In addition to previously existing schemes, direct payments to agriculture were introduced. Co-financing grant schemes to micro, small and medium-sized enterprises, worth a total of € 1 million were introduced. In 2014, the government declared three new free economic zones (Prishtinë/Priština, Mitrovicë/Mitrovica, Gjakovë/Đakovica and Prizren). However, this was done without the required national plan, on a rather ad hoc basis. The institutional setup to screen, approve and monitor existing and planned state aid schemes has not yet been established and no inventory of the state aid scheme is available. The Competition Authority in charge of establishing and securing a competitive environment is not operational. In June 2013, the Ministry of Trade and Industry launched a feasibility study on the credit guarantee scheme aiming to provide credit to businesses at subsidised interest rates. However, the implementation process has not yet started due to several delays. ***Overall, the state interference in the economy remains high. There was no progress regarding institutional capacity to control state aids as subsidies are still being provided without a proper strategy and evaluation. The Competition Authority needs to become functional to enable progress towards establishing a functioning competitive market.***

Economic integration with the EU

Kosovo's openness to trade decreased in 2013 as total trade stood at 66.4 % of GDP compared to 70.4 % of GDP in 2012. EU and Central European Free Trade Agreement (CEFTA) countries continue to be the main trade partners with shares of total trade at 43.8 % and 28.5 % respectively. EU countries remain the biggest foreign investors in Kosovo, with a share of 35 % of overall investment. ***Overall, the EU remained Kosovo's biggest trade and investment partner.***

7.3. CONCLUSIONS

As regards the economic criteria, Kosovo made limited progress on its path to become a functioning market economy. Substantial efforts are needed to tackle structural weaknesses to cope with competitive pressures and market forces within the Union over the long term.

Economic growth remained positive at 3.4 % but did not yield any improvements in labour market conditions. High external imbalances persist despite some narrowing of the trade deficit. Macroeconomic stability was broadly preserved despite significant pre-election ad hoc increases in current expenditure, in particular on wages and pensions. Such practice deteriorates the transparency, predictability and credibility of fiscal policy, complicates fiscal planning and shifts the composition of spending towards less growth-friendly expenditure.

Strengthening fiscal planning and effectively implementing the fiscal rule is vital. Moreover, decisions on large infrastructure projects, such as in the transport sector, should be based on proper cost-benefit evaluations to maximise economic benefits. In view of the persistent and very high unemployment, efforts should be undertaken to facilitate private-sector development through improvements in the business environment. To that end, obstacles arising from weak administrative capacities, difficult access to finance and lengthy and complex privatisation procedures should be swiftly addressed. Kosovo must ensure a properly functioning legal and judiciary system, enhance contract enforcement and effectively reduce delays in courts. Economic statistics need to be improved.

ANNEX

Abbreviations

BiH	Bosnia and Herzegovina
CBBH	Central Bank of Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EFPs	Economic and Fiscal Programmes
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross domestic product
ILO	International Labour Organization
IMF	International Monetary Fund
MTEF	Medium-Term Expenditure Framework
NERP	National Economic Reform Programme
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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