EUROPEAN ECONOMY

Occasional Papers 44 | March 2009

Progress towards meeting the economic criteria for accession: the assessments of the 2008 Progress Reports

Directorate-General for Economic and Financial Affairs

Economic and Financial Affairs
DIRECTORATE-GENERAL

EUROPEAN COMMISSION

Occasional Papers are written by the Staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The "Papers" are intended to increase awareness of the technical work being done by the staff and cover a wide spectrum of subjects. Views expressed do not necessarily reflect the official views of the European Commission.

Comments on the report would be gratefully received at the following addresses:

DG ECFIN - Unit B3
Directorate-General for Economic and Financial Affairs
European Commission
Giuseppe Carone
Rue de la Loi 200
B-1049 Brussels

E-mail: ecfin-secretariat-b3@ec.europa.eu

This paper exists in English only and can be downloaded from the website
http://ec.europa.eu/economy_finance/publications

A great deal of additional information is available on the Internet. It can be accessed through the Europa server (http://europa.eu)

KC-AH-09-044-EN-C
ISSN 1725-3195
ISBN 978-92-79-11258-4
doi: 10.2765/4100

European Commission
Directorate-General for Economic and Financial Affairs

Progress towards meeting the economic criteria for accession:
The assessments of the 2008 Progress Reports

EUROPEAN ECONOMY Occasional Papers No 44

CONTENTS

INTRODUCTION

INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2008 Progress Reports on progress made towards meeting the accession criteria of each candidate and potential candidate country. The European Commission adopted these Reports on 5 November 2008. This introduction explains the methodology underlying these Reports that the Commission has been following since 1997 in order to carry out these assessments.

The purpose of this Occasional Paper is to facilitate the work of those scholars, researchers and analysts of the enlargement process, who are mainly interested in the economic aspects. As such, it represents only a part of the overall progress made by the candidate and potential candidate countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2008 Progress Reports.

The methodology of the Progress Reports

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

The criteria are:

- the political criteria - stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;

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

- the institutional criteria - the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union, which includes the whole range of policies and measures that constitute the acquis of the Union. Candidate countries must adopt, implement and enforce the acquis. This requires the administrative capacity to transpose European Community legislation into national legislation, to implement it and to effectively enforce it through appropriate administrative and judicial structures.

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

Regarding the economic criteria, the Commission has examined progress achieved during each year on the basis of a number of subcriteria 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.

The economic chapters of the Progress Reports assess each candidate and potential candidate country in the light of progress made with respect to these economic conditions.

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 assessments in the Progress Reports are backward-looking over the reporting period of one year , they refrain from attempting to forecast possible future developments. Furthermore, the reports do not attempt to provide explicit policy advice, but rather track recent developments on a factual basis.

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 conclusions for candidate countries on the one hand and potential candidate countries on the other hand should be noted. Namely, in the case of candidate countries the conclusions summarise the state of compliance with the Copenhagen economic criteria (= level of compliance), while in the case of the potential candidate countries they rather refer to the progress achieved towards compliance. The reason for this is that for candidate countries the Commission has already assessed the level of compliance for the first time in its opinions on the countries' EU membership applications. This exercise has not yet been undertaken for potential candidate countries, and therefore the assessment and the conclusions can naturally only refer to further progress achieved rather than to level of compliance. The latter will only be assessed at a later stage, in a Commission opinion once requested by the Council, and following a potential candidate countries' application for EU membership.

Assessment of the 2008 Progress Report

1. CROATIA

1.1. INTRODUCTION

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

1.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The country participates in the EU Pre-Accession Fiscal Surveillance procedure. The Pre-accession Economic Programme (PEP) 2008-2010, submitted in December 2007, presents a coherent medium-term framework for economic policies. If fully implemented, it would improve the functioning of markets and support sustainable growth and real convergence. Political consensus on the essentials of market economy has been maintained. However, an ad-hoc approach to economic policies has often prevailed and a deepening of structural reforms has not figured among the governments' top priorities. The structural reform agenda has moved slowly and there has often been a gap between legislative intent and actual implementation. Policy coordination within the government as well as the government's communication with the Croatian National Bank (CNB) has not been systematically enforced. Overall, consensus on the fundamentals of a market economy has been maintained, but the government's approach to economic policy and reform has sometimes lacked a strategic medium-term orientation.

Macroeconomic stability

In 2007, annual GDP growth showed a marked acceleration to 5.6%, up from 4.8% in 2006, but started to slow in the last quarter of the year. Growth continued to be fuelled by strong domestic demand. Private consumption in 2007 recorded the highest growth rate since 2002 and accelerated strongly to 6.2%, from 3.5% a year before. It remained driven by strong, but slowing credit growth and debt repayments to pensioners, the latter amounting to 1.2% of GDP. The growth of public consumption also increased markedly to 3.4%, to a large extent resulting from pre-election spending increases. Both private and public investment slowed and total investment growth decelerated from 10.9% to a still robust 6.5%. Both the growth of exports and imports declined to 5.7% and 5.8%, respectively, and the contribution of net exports to GDP growth remained negative. On the supply side, the industrial sector added the strongest contribution to growth. Also, the good performance of some services, in particular financial intermediation, retail trade and tourism supported the economic expansion. In the first half of 2008, economic growth decelerated markedly to 3.8% year-on-year, down from 6.8% in the same period a year ago, partly due to slowing exports. At the same time, some rebalancing took place, as consumption moderated amid stronger investment activity. Average per-capita income in 2007 rose to 55% of the EU-27 average from 52% in 2006. Overall, the economic performance remained robust amid some moderation of growth.

The current account deficit continued to widen, from 7.9%of GDP in 2006 to 8.7% in 2007 and to 10.5% in the four quarters to June 2008, mainly due to a rising trade deficit. Relatively strong domestic demand and imports, higher world commodity prices as well as a recent decline in export growth resulted in a widening of the trade gap to 26.3% of GDP . As in previous years, roughly two thirds of the trade gap were covered by the surplus in services, mainly tourism and transport. The deficit in the income balance dropped somewhat due to higher income on equity investments and on foreign exchange reserves. The surplus in transfer payments declined, mainly due to lower government revenues from abroad. In sum, despite strong tourism revenues and higher income from abroad, external deficits have continued to widen, on the back of strong import demand, higher world commodity and energy prices and lower export growth.

FDI remained the main source of foreign financing. In the four quarters to June, the value of net FDI inflows declined by 13.5% year-on-year, representing 7.7% of GDP and thus financing a still large part of the current account deficit. Net inflows were largely driven by the recapitalisation of banks as well as by investments in wholesale trade and the insurance sector, while greenfield investments remained shallow. Owing to continued net capital inflows, official foreign reserves increased to around € 9.3 billion by end-December 2007, and further to € 9.8 million in August 2008, equivalent to around 5.5 months of total imports. The stock of external debt continued to increase markedly by 14% in the twelve months to August 2008, but the share of short-term debt remained relatively low at 13.2%. The external debt ratio reached 87.8% of GDP at end-2007 , up from 85.5% a year before. The share of the domestic banking sector in total external debt declined, as banks reduced their outstanding external obligations during 2007, also in response to central bank measures aimed to contain banks' foreign borrowing. The corporate sector increased its external indebtedness significantly, partly reflecting the circumstance that domestic banks were encouraging their corporate clients to borrow directly from parent banks abroad, thus circumventing their own borrowing restrictions. The increased exposure of the domestic non-tradable corporate sector to foreign borrowing has become a cause for concern and warrants careful monitoring. In sum, capital inflows remained strong and external debt continued to rise, driven by strong foreign borrowing by the corporate sector.

So far, the international financial crisis has only mildly affected the Croatian economy and its financial sector. However, a widening current account deficit and a high level of external indebtedness create important external financing needs requiring significant capital inflows. To that extent, the external imbalances render the Croatian economy vulnerable to possible disruptions in capital flows. The risk of a sudden stop or reversal of capital flows seems limited, but the pace of cross border lending, which has become an important financing source for the domestic corporate sector, could be affected. Higher risk premiums and refinancing costs have already started putting some pressure on the external side. The comfortable foreign exchange reserve position serves as an important cushion in the event of slowing capital inflows. The Croatian authorities lifted the marginal reserve requirement for banks' foreign borrowing to boost their foreign exchange liquidity. Moreover, the deposit insurance law was amended by Parliament, leading a fourfold increase of the guaranteed amount of household deposits (to € 56,000).

Positive trends on the labour market continued. Data from the labour force survey confirm strong employment growth of 2.7% in 2007, which contributed to an increase in the average employment rate to 57.1%, up from 55.6% in 2006. The unemployment rate (ILO) fell from 11.1% in 2006 to 9.6% in 2007. Unemployment declined for all age groups, but still remained high for the young population (at around 24%). The long-term unemployment rate decreased to 5.9% (2006: 6.7%). The officially registered unemployment rate declined to 12.4% in July 2008, compared to 13.7% in July 2007. Labour market developments continued to be characterised by a relatively low job turnover, suggesting rigidities and limited employment restructuring. The growth of average gross wages stayed at 6.2% in 2007, as in 2006, and accelerated to 7.1% in the first half of 2008. Average real wage growth declined, however, due to rising inflation. Overall, the labour market performance continued to improve, but high youth and long-term unemployment and limited job turnover remain a cause for concern.

No major changes occurred with respect to monetary policy. Following the positive experience of previous years in stabilising inflation expectations through a stable exchange rate, the tightly managed float remained in place. Exchange rate stabilisation has also contributed to mitigating significant balance sheet risks under a highly euro-ised financial system. In the last quarter of 2007 and in 2008, the CNB intervened three times in the foreign exchange market and purchased euro for a total amount of around EUR 712 million. Despite a continued surge in capital inflows, the nominal exchange rate of the kuna vis-à-vis the euro has been kept stable. The average daily exchange rate fluctuated within a very small range between 7.16 and 7.35 kuna per euro and appreciated by 2.4% in the twelve months to end-September 2008. Overall, the stable exchange rate policy has served the country well and remained a factor of monetary and financial stability.

Reacting to stronger inflationary pressures the CNB gradually increased its marginal repo rate from late 2007 onwards. Moreover, the CNB continued to rely on administrative and prudential measures in order to contain strong capital inflows and rapid credit growth. Marginal reserve requirements on banks' foreign borrowing as well as credit controls remained in place. They were partly adjusted in late 2007 and 2008 to more effectively raise domestic banks' borrowing costs. Partly as a result of these measures, the annual growth of domestic credit to the private sector decelerated from around 23% in 2006 to 15% in 2007 and to 11.2% in August 2008. Both the growth of lending to private households and to the corporate sector dropped. The moderation of lending to the corporate sector, however, also reflects ongoing financial disintermediation of lending, as some corporations turned to direct borrowing from abroad. Overall, in an attempt to contain rapid credit growth, monetary policy continued to rely on administrative measures and credit controls.

Average annual inflation decreased slightly in 2007 to 2.9%, down from 3.2% in 2006. This was due to low carry-over effects from 2006 and low inflation throughout the first half of the year. However, inflation accelerated significantly in the second half of 2007 to 5.8% year-on-year in December, and further to 6.4% in September 2008, compared to 2.1% in December 2006. This acceleration was mainly due to supply shocks linked to considerable increases in the prices of agricultural, food and energy products. Moreover, big increases in administered utility prices, most of which are controlled by local governments, also added to higher inflation. To some extent, increases in household disposable incomes, arising in particular from pension debt repayments and higher government transfers, added to price pressures. There is evidence that rising inflation has led to second-round effects. Core inflation accelerated to 6.5% in August 2008, compared to 3% a year before, and producer price inflation reached one of the highest levels ever recorded (11%). Overall, inflation has increased markedly on the back of higher commodity and energy prices and strong domestic demand.

Fiscal developments in 2007 and in the first half of 2008 benefited from a growing economy and strong revenues, which increased by 13% and 11.5% year-on-year, respectively. Current spending recorded an increase of 10.8% in 2007 and 10.2% in the first half of 2008, fuelled by a strong rise in spending on goods and services as well as on subsidies. In 2007, the general government deficit was reduced as planned, to 1.6% of GDP, down from 2.5% in 2006 (in ESA 95 terms). However, fiscal accounts do not include a number of off-budget operations, such as debt repayments to pensioners (1.2% of GDP in 2007) and quasi-fiscal activities of the State Development Bank (HBOR). Therefore, the actual fiscal policy stance has been more expansionary than the headline budget figures suggest. A revised budget for 2008 was adopted in July and foresees a budget deficit that is slightly lower than originally planned (1.3% instead of 1.6% of GDP), although the main reason for this is the ad-hoc exclusion of the public motorway company from the general government accounts. As in previous years, the revised budget provides for higher than originally projected revenues. They are again used to repay health sector arrears, but also to compensate private households for higher energy prices, and to provide additional funds for regional development as well as for science and education. The stock of general government debt stood at 37.8% of GDP at end-2007, down from 40.8% a year before, and fell further to 34% by June 2008. However, adjustments for the stock of issued State guarantees and the debt of the State Development Bank (HBOR) would raise the stock of debt by around 10 percentage points of GDP. Overall, deficit reduction continued as planned, but actual fiscal policy has been more expansionary than the reported figures suggest. Stronger expenditure restraint remains essential in view of higher inflation and widening external imbalances and as a way to better support monetary policy.

The rationalisation of public spending remained a key public finance objective. The implementation of the social benefits reform strategy adopted in (April) 2007 continued. Its aim is to reduce the number of benefits and to achieve a better targeting of social welfare. However, means- and income-tested benefits as a share of total benefits have remained relatively small while categorical benefits still account for the large majority of social benefits. Although some institutional progress has been made with the establishment of a personal identification number and one-stop shops, the social welfare system remained burdened by complex eligibility criteria and inefficient administration. No new measures have been taken to effectively address the health sector's financial difficulties and arrears continued to accumulate. In particular, the reform of co-payment exemptions through a wider use of means- and income-testing has made little progress. In the context of the 2008 budget revision, the government - as in the previous year - bailed out health sector payments arrears. No measures have been taken to reform the pension system's first pillar. Overall, limited progress has been achieved in terms of increasing the efficiency of public spending.

The government declared itself committed to a comprehensive Treasury Reform Strategy as a sound basis for improving expenditure management and budget control systems. The role of the Ministry of Finance in the budget preparation process has been strengthened. Continued progress was achieved in enhancing institutional and analytical capacity for setting up medium-term macroeconomic and fiscal frameworks. However, public finances still suffer from the absence of a real medium-term expenditure framework which links defined policy priorities to the budget planning process. Some progress has been made in enhancing public debt management capacity, but a fully-fledged strategy is still lacking. Transparency of the issuance policy has remained weak and raises concerns about asymmetric access to information by potential market participants. Efforts were made to reconcile current budget statistics with ESA 95 standards, but important quasi-fiscal operations as well as local governments remained unrecorded, seriously undermining budget transparency. Overall, analytical and institutional capacity in public finance has been further strengthened, but strategy-based budget planning and debt management remained generally weak.

The direction of macroeconomic policies has, on the whole, been appropriate to contain potential external vulnerabilities. Given the limited scope for monetary policy discretion under heavy financial euro-isation, the onus of containing the savings-investment gaps in the economy has remained largely on fiscal policy. Fiscal consolidation has so far benefited markedly from strong revenue growth. However, a credible and sustainable fiscal adjustment process requires much more efforts in accelerating social benefit, health care and pension reforms to bring down the relatively high public spending ratio.

Interplay of market forces

The state continued to gradually withdraw from the productive sector. The sale of 7% of shares of the national oil company INA was successfully completed in late 2007. In June 2008, the government sold 4.2% of Hrvatski Telekom (HT) and 12.5% of a fertilizer company. In all three cases shares were sold to current and former employees. However, the privatisation of assets held by the State Privatisation Fund made only limited progress. A major corruption investigation into the Fund in 2007 led to a de facto suspension of the privatisation process. In early 2008, the government appointed a new head, as well as a new Fund management board, and changed decision making procedures to lend a new impetus to the process. Up until September 2008, the State Privatisation Fund had sold or liquidated some 30 companies and the remaining portfolio still comprised around 891 companies, with the State keeping a majority holding in 97 of them. A number of tenders did not succeed in attracting the interest of potential investors. The private sector’s share in output and employment has risen to slightly above or close to 70%, respectively. Overall, progress in privatisation has been uneven and continued to be undermined by institutional weaknesses.

Market entry and exit

Company registration procedures have been further simplified. The average time and number of procedures needed to set up a business, as well as average registration costs, have been reduced further. The number of newly registered companies grew by 1.4% and the stock of active businesses increased by 13% year-on-year in March. An e-register of national regulations has been produced, allowing all regulations to be found in one place. On the other hand, Croatia's performance continues to be relatively unsatisfactory in several measures of the quality of the business environment. Limited progress has been made in advancing the "Regulatory Guillotine" project aimed at simplifying or eliminating regulations that are deemed unnecessary. Doing business in various sectors remained hampered by lengthy and cumbersome procedures for obtaining licences or authorisations at the national and municipal level. Overall, further progress has been made in simplifying company registration, but the business environment continued to suffer from excessive regulations and ad-hoc requirements.

Legal system

Further progress was made in reducing the backlog of cases before Croatian courts. During 2007, the backlog was reduced by 6.1% compared to 2006. However, there is still a large backlog (969,100 cases at end-2007) and the judicial system has remained inefficient. The weaknesses of the judicial system may discourage economic actors from taking cases to court and undermine effective enforcement of creditor and property rights.

Development of the financial sector

The financial sector, still dominated by banks, represented around three quarters of total assets at end-2007. Some 95% of banks are privately owned and the share of foreign ownership remained high at 90%. The number of banks was unchanged at 33, which is relatively high in relation to the market size. The degree of market concentration has remained at a moderate level and has generally not been an impediment to market competition. The five largest banks together accounted for a market share of around 68% at the end of 2007, down from 72% in 2006. The spread between the weighted average of new kuna-denominated loans and new kuna-denominated deposits did not change significantly. Domestic private credit rose to 73% of GDP in 2007, up from 69% in 2006. Overall, the largely private and foreign-owned banking sector remained the key player in financial intermediation.

The banking sector has become more resilient as a result of a number of prudential and supervisory measures that have been taken to address potential macro-financial vulnerabilities. Additional capital requirements were imposed on fast-growing banks, and risk weights on un-hedged foreign currency loans were increased. Banks' capital adequacy, asset quality and profitability remained at comfortable levels. The share of non-performing assets remained at a relatively low level of 3.2% in June 2008, although this indicator may underestimate portfolio risks during periods of strong asset growth. However, the banking system still has to contend with interest and exchange rate induced credit risks, as the majority of loans are based on variable interest rates and linked to foreign exchange. Very good progress has been made in the central bank in fostering the analytical capacity to produce forward-looking financial sector stability assessments. Overall, additional prudential measures served to make a generally sound banking system even more resilient and reduced potential macro-financial risks.

The share of non-banking financial sector assets in total financial sector assets increased from 23.4% at end-2006 to 26 % by end-2007, also due to the strong asset growth of investment funds and mandatory pension funds. In 2007, domestic stock markets generally benefited from the strong growth of non-bank institutional investors and increased interest from the general public in equity investments, although the turnover remained low. This resulted in a strong increase in the stock market index by 60%, taking market capitalisation to around 128% of GDP at end-2007, as against

79% in 2006. Since the start of the year, the Croatian stock market has been rather volatile and the Zagreb stock exchange index lost around 50% in the first ten months. Market capitalisation had declined to 90% of GDP in June 2008. Bond market capitalisation amounted to 13% of GDP in June 2008, slightly lower than a year before, as the market capitalisation of the corporate sector declined. The supervision and regulation of the non-banking financial sector has gradually improved. The previously unregulated leasing sector has been brought under the oversight of the non-bank supervisor HANFA. Also, HANFA and the Croatian stock exchange have adopted the Croatian Corporate Governance Codex, which, if properly applied, should enhance the transparency and efficiency of the capital market. In general, notwithstanding the growth of some market segments, capital markets remained shallow, with little turnover.

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

Existence of a functioning market economy

Macroeconomic stability has been largely maintained and has allowed economic agents to make decisions in a climate of stability and predictability, thus supporting the functioning of market mechanisms. However, significant state interventions in the economy as evidenced by a high spending ratio and high subsidies, as well as prevailing obstacles to private sector development, continued to partly undermine a more growth-oriented allocation of resources, constraining the potential for higher productivity and catching-up.

Human and physical capital

Reforms in the education sector have continued under the Education System Development Plan for 2005-2010. Further steps were taken to improve the quality of education at all levels. A national programme aims to increase the rate of enrolment in and completion of secondary education and to reduce the percentage of early school leavers. However, the education sector continued to suffer from out-dated curricula and poor equipment. The joint assessment of employment priorities was signed by the Commission and the Croatian authorities. The government continued to implement active labour market policies. These include training and employment subsidies for young people without work experience, the long-term unemployed, older persons and vulnerable groups. However, although there was a slight increase in employment and participation rates, the levels remained relatively low - at 57% and 63.2% respectively in 2007. Overall, the labour market continued to suffer from mismatches between supply and demand.

Investment continued to be robust in 2007 and 2008, albeit growing at a slower pace, and the fixed investment ratio remained high at around 30% of GDP in 2007. Total spending on research and development remained at the relatively high level of around 0.9% of GDP. Public investment in transport remained strong. In particular, investments in new highways amounted to 1.9% of GDP and resulted in a further expansion of the network. Most of the core main lines of the rail network are sufficiently well maintained to allow a competitive freight transport business. FDI continued to play a significant role. The total stock of FDI reached EUR 17.6 billion (47% of GDP). The largest share of cumulative FDI inflows is accounted for by the financial sector (36%), followed by manufacturing (27%), and post and telecommunications (10%). There has still been little greenfield investment, and private investments in the processing and manufacturing industry have remained relatively low, limiting technological change and export potential. To conclude, strong levels of investment continued to be concentrated in transport infrastructure and the services sector.

Sector and enterprise structure

The loss-making, state-owned aluminium company (TLM) was sold following lengthy tender procedures and negotiations. Subsequently, the new owner submitted a restructuring programme to the government. Following the privatisation of the two steel mills, the government adopted a revised National Restructuring Plan for the steel industry. In the area of shipbuilding, the government adopted revised individual restructuring plans, as well as taking a decision to restructure six shipyards through a process of privatisation. The privatisation process is expected to start immediately and to be completed by the end of 2009. However, details concerning methods and conditions for sale have not yet been agreed. Overall, there has been mixed progress with the restructuring of large loss-making companies.

The restructuring of the loss-making large railway carrier has made very limited progress. The objectives of the business plan for 2007, in particular significant staff reductions and a wage freeze, were not met. The envisaged reduction of the working ratio in 2007 did not materialise, and the ratio even started to worsen in 2008. The railway sector continued to require high levels of budget support (above 1% of GDP in 2007). Low productivity and high unit labour costs continue to undermine its long-term viability, necessitating vigorous action, including staff lay-offs and the closure of non-profitable lines. Four railway subsidiaries were tendered for privatisation, but have not yet been sold. The liberalisation of the telecommunication industry continued. The Croatian Telecommunications Agency continued with activities aimed to stimulate market competition by improving market access to new service providers. This led to further price reductions and to a larger choice of tariff packages for customers. New fixed line competitors raised their market share further from 13% to a still modest 19%, but the incumbent Croatian Telecom remained by far the dominant operator. The liberalisation of the energy sector continued to advance gradually with the opening of the electricity market to private households as of 1 July 2008. While this marks an important formal step towards more competition, the large public energy company HEP remained de facto the only energy supplier. Moreover, the restructuring of HEP has not seen any progress. Overall, the reform of network industries made headway, but the railway sector needs much deeper restructuring in order to ensure its long-term viability and competitiveness.

The already large service sector increased its share of total output to 63%. Agriculture's share of output declined further to 6.8% in 2007. The share of construction and industry together accounting for around 32%, remained unchanged. Agriculture's declining share of employment fell to 13%, while industry and construction rose to above 30% and the services sector maintained its share of around 56%. Given the already large service sector, there were only marginal shifts in the sector structure of the economy.

The small and medium-sized enterprise (SME) sector continued to grow in 2007, representing more than 40% of the corporate sector's total assets, 66.2% of total employment and 65% in total investment. SMEs generated more than 45% of GDP and accounted for an increasing share (above 40%) of total exports. The government decided to extend the existing support schemes for SMEs by adopting a new medium-term programme (2008-2012). However, the sector continued to suffer from a cumbersome regulatory framework and inefficiencies in public administration. Access to longer-term financing remained difficult, particularly for newly established businesses. Overall, the SME sector has gained in importance, despite the remaining administrative obstacles.

State influence on competitiveness

The government has taken short-term measures to alleviate the impact of higher energy prices on households, such as increasing income tax allowances and granting subsidies to the electricity company. However, as price subsidies are linked to the level of consumption, it remains doubtful whether these measures will be effective in targeting the most vulnerable parts of the population.

Also, they may risk distorting necessary price signals. The role of the Competition Agency in monitoring and controlling State aid has been further strengthened, but the relatively low staffing levels continued to be an urgent problem. The total amount of subsidies in the 2007 and 2008 general government budgets remained high - at 2.6% of GDP - and a large share has still been provided to loss-making companies. Horizontal aid accounts for only a small share of total subsidies. Overall, state intervention in the enterprise sector remained substantial.

Economic integration with the EU

Croatia is an open economy with total trade in goods and services representing more than 100% of GDP. Apart from the export of transport equipment (mainly ships), tourism continued to be the biggest source of export revenue, representing almost 18% of GDP in 2007. The EU has continued to be the most important trading partner, although its share in total Croatian exports and imports fell by a few percentage points to 60.9% and 64.8%, respectively. At the same time, Croatia has expanded its trade with neighbouring countries, also reflecting ongoing regional trade integration. Around 97% of FDI inflows originate from EU Member States. Overall, integration with the EU in the areas of trade and investment remained very high, and trade with neighbouring countries has continued to grow.

The average growth in real wages stood at around 3% in 2007, and remained in line with estimated changes in average labour productivity, with the result that real unit labour costs remained largely unchanged. The nominal effective exchange rate of the kuna appreciated by 3.2% as a result of strong upward movement against the US dollar. In real effective terms , the kuna appreciated at a somewhat higher rate (3.8%), reflecting a slightly faster growth of domestic producer prices relative to producer prices abroad. Overall, standard indicators do not point to significant changes in export price competitiveness.

1.4. CONCLUSIONS

The **economy** of Croatia continued to benefit from a solid performance. Growth has decelerated as domestic demand has started to ease. Macroeconomic stability has been preserved, but inflation has risen considerably, largely due to higher energy and food prices. So far, the Croatian economy has been only mildly affected by the financial turbulences, but higher external deficits and debt levels have increased external vulnerabilities. The process of structural reforms has generally been slow. There is an urgent need to build on existing progress by further improving the business environment.

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

Political consensus on the fundamentals of a market economy has been maintained. In an increasingly uncertain international environment, stability–oriented macroeconomic policies have been preserved. The stable exchange rate policy has served the country well and remained a factor of financial stability. Fiscal consolidation led to a further reduction of the general government deficit, but the existence of quasi-fiscal operations may imply additional fiscal risks and undermines budget transparency. Economic growth remained solid with some rebalancing, as consumption slowed and private investment picked up further.

The labour marked benefited from high employment growth and unemployment continued to decline. The technical and institutional capacity in public finance was further strengthened. Additional prudential measures led to a stronger resilience of the generally sound banking sector and reduced macro-financial risks. Croatia's economy is well integrated with the EU.

However, the government's economic policy has sometimes lacked a clear medium-term orientation. The structural reform agenda has moved slowly and there has often been a gap between the adoption of policy strategies and their actual implementation. The government's communication with the Central Bank has at times been weak, adversely affecting the quality of policy coordination. Higher inflation and rising external imbalances pose risks to macroeconomic stability and require stronger fiscal consolidation. Limited progress has been achieved in increasing the efficiency of public spending, in particular in the health sector. Social spending remained high and was not properly targeted, leading to inefficiencies. Public finances still suffer from a lack of strategy-based budget planning and implementation.

Significant subsidies to enterprises have not been used effectively for restructuring and privatisation continued at an uneven pace. Further progress has been made in facilitating business registration procedures but private sector initiative continued to be hampered by excessive regulations and ad-hoc requirements, potentially undermining market entry and exit procedures. Reinforcing and deepening structural reforms with more determination remains of high importance.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. INTRODUCTION

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

2.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The country is fully participating in the EU's Pre-accession Fiscal Surveillance. It presented its second Pre-accession Economic Programme in December 2007 and submitted the third fiscal notification in April 2008. Cooperation with the International Monetary Fund (IMF) and with the World Bank have been important corner-stones of the country's economic policy framework. However, in September, the authorities announced their intention not to enter into another IMF arrangement for the time being. Furthermore, a number of medium-term strategies define the policy framework, such as the Public Investment Programme for 2008-2010 and the Public Debt strategy for 2008-2010. Political consensus on the essentials of a market economy has been maintained. Nonetheless, implementation of reforms slowed down before and after the elections. Overall, a broad political consensus on the fundamentals of economic policy has been maintained.

Macroeconomic stability

Output growth accelerated to 6% in the first half of 2008, compared to 5% in 2007 and 4% in 2006. The main factors underpinning growth were investments and private consumption. Export growth has slowed down, while import growth remained strong, reflecting buoyant domestic demand. Industrial production rose by an average of around 10% during the first eight months of 2008, compared to some 2.5% for the same period the year before. Overall, economic activity has remained stronger than in the past.

The current account deficit widened markedly from autumn 2007, reflecting a less favourable global environment with decelerating global demand and increasing energy prices, but also strong domestic demand. In the last quarter of 2007, the current account went from a surplus of nearly 2.5% of GDP to a deficit of 3% of GDP for the whole year. This trend continued and by mid-2008 had pushed up the current account deficit to some 13% of GDP. The main factors were higher expenditures for imports, mainly for fuel but also machinery. On the other hand, capital inflows rose markedly, in particular FDI, which reached 6.5% of GDP on an annualised base, compared to 2.8% of GDP the previous year. Overall, external imbalances widened sharply, putting an end to several years of overall balanced current account outcomes.

Official reserve assets of the National Bank of the Republic of Macedonia (NBRM) increased slightly in absolute terms to some €1.6 billion by September However, due to a strong increase in expenditures for imports, the import coverage with foreign exchange reserves has dropped to around three months of expected imports. Gross external debt started to rise again towards the end of 2007, after early debt repayments had resulted in a declining ratio for most of the year. By end June 2008, gross external debt had increased by some 6 percentage points of GDP (to 50% of GDP, compared to 44% the year before), mainly as a consequence of increased borrowing abroad by a few foreign-owned companies. The country's per capita income, measured in purchasing power standards (PPS), reached 29% of the EU-27 average in 2007, compared to 27% the year before. Overall, the country's position with respect to foreign exchange reserves and external indebtedness has still remained sound. However, in view of the recent widening of the trade deficit, the country's external vulnerability has increased significantly.

So far, the international financial crisis has had only a very limited impact on the economy and its financial sector. However, the recent widening in the current account deficit creates an important external financing need requiring significant capital inflows, which in the past has been mainly financed by workers remittances. The level of foreign debt is relatively low and the risk of a sudden stop or reversal of capital flows seems limited. However, the external imbalances render the economy vulnerable to possible disruption in capital flows.

The situation in the labour market improved slightly and the unemployment rate saw a marginal decline. The number of employed persons rose some 3.5% during the first half of 2008, compared to nearly 4% in the first half of 2007. The number of unemployed declined by about 1.5% during the last year, which brought unemployment down to 33.8% in mid-2008, which is about 1 percentage less than a year ago. A significant share of unemployment is structural in nature, partly resulting from a mismatch between required and available qualification. As a result, employment growth is fed mainly by an increase in labour supply, while the decline in the number of unemployed is significantly less dynamic. There has been a significant amount of job creation in low value added sectors, such as agriculture. About 20% of the unemployed are aged between 15 and 24. The unemployment rate in this age group is still very high (56% in the first half of 2008), but has marginally declined in line with the overall marginal decrease in unemployment. The existence of a substantial informal sector might lead to a significant over-estimation of actual unemployment. However, even when taking this factor into account, unemployment is still an important issue, in particular among young people and less educated. Overall, the trend of a slightly improving labour market situation has continued, although unemployment is still at very high levels. The persistently high unemployment points to structural weaknesses, such as skill mismatches, and an insufficient functioning of the labour market. In addition, slow expansion of productive capacities hampers job creation.

The Central Bank has managed to maintain the exchange rate of the denar at a stable level of 61.2 denar to the euro and has continued with a de-facto peg. With the exception of the Lombard rate, the Central Bank left the other policy rates unchanged, Interest rates of the private sector started to rise moderately. Rates for Central Bank bills rose from 4.8% in October 2007 to 7% by June 2008. The short-term lending rates of commercial banks showed a moderate decline from 8.2% at the end of October 2007 to 8.0% in February, but rose to 8.6% by June 2008. The high growth of credit to the private sector continued, at some 40% (year-on-year) during the first half of 2008, but has slowed down since then. The volume of broad money (M4) rose by 32% year-on-year during the first half of 2008, but also moderated since then. Overall, exchange rate and monetary policy have remained sound, which has helped to maintain confidence in the stability of the financial system.

Average annual inflation slowed in 2007 to 2.3%, compared to 3.1% in 2006. However, in the last months of 2007, sharply increasing food and energy prices led to an acceleration in headline inflation, which reached 6.1% in December 2007 and continued to rise to nearly 9% in March and April 2008 (year-on-year basis). Since then, year-on-year inflation rates have declined, slipping to 7.1% in September 2008. The strong increase in inflation is mainly due to higher food and energy prices, which – owing to the high share of consumer spending on food – has a significant impact on the costs of living. Overall, inflation has accelerated markedly.

The fiscal stance has become more expansionary with a planned general government deficit of 1.5% of GDP in 2008, compared to an actual fiscal surplus of 0.6% of GDP in 2007. The fiscal performance in 2007 and 2008, as in previous years, was characterised by higher than expected revenues and lower than planned investment expenditures. At the end of 2007, the authorities adopted additional spending measures amounting to some 2% of GDP, while in July 2008 the parliament approved a supplementary budget with further spending measures amounting to some 4.25% of GDP in order to meet fiscal targets. The additional budget envisages more funds for education, compensation for the high oil prices, job creation and support for workers of companies that have gone bankrupt. As in the past, the continued underestimation of revenues and the difficulties in implementing investment projects highlight administrative weaknesses in this sector. Overall, while fiscal policy programming has become more expansionary, actual revenue and expenditure outcomes are tending to show unanticipated surpluses.

Implementation of fiscal decentralisation continued. By mid-2007, the number of included municipalities has been increased to 62, covering some 84% of the country's population. Furthermore, the tax base of the municipalities has been widened by amendments to the property tax law and the new Law on Roads. Overall, the budgets of those municipalities amount for some 6% of GDP. Municipal debts have been reduced further, from about 0.75% of GDP in 2005 to some 0.25% by 2007. The new competences continue to represent significant challenges to the municipalities and require close monitoring by the central authorities.

General government debt has declined to around 21% of GDP by mid 2008 . The authorities have continued to improve the efficiency of tax administration and to simplify the tax system. Overall, the public sector accounts have remained largely in balance and the efficiency of tax collection has been improved. However, the quality of public finances continues to be hampered by weaknesses in medium-term budgetary planning and priority setting, leading to a high proportion of discretionary and short-term spending decisions.

The country's fiscal and monetary policy mix remained largely in line with the country's need to accelerate economic activity. However, in view of the recent deterioration in external balances, the importance of maintaining a sound economic policy mix has increased. Fiscal policy benefited from a strong revenue performance, while the objective of substantially balanced public sector accounts was largely achieved. The country's resilience to shocks remained intact, despite increased pressures due to a sharp increase in food prices and a rapid widening of external imbalances. Employment rose, reflecting the benefits of stronger growth but also reflecting progress in reducing unregistered economic activities. Overall, the macroeconomic policy mix was largely in line with the aim of maintaining economy stability, although very high unemployment remains a key challenge.

Interplay of market forces

Privatisation has largely been completed. The share of the private sector in total output is about 80% of the value added. The value of State-owned assets stands at some 13% of GDP, with five State utilities accounting for some 12% of GDP. The value of State-owned assets in the remaining 53 companies amounts to some 1% of GDP. Some 10 000 people or about 1.3% of the labour force are employed in companies with a majority State ownership. No further privatisation took place, apart from the privatisation of some radio stations. Overall, the free interplay of market forces has remained unchanged but is already well advanced

Market entry and exit

The government took further steps to improve the legislation on the "one-stop-shop" system for starting a business. As a result, in 2007 the average time to register a company was cut from 3 days to 26 hours. Since early 2008, the law requires that registration should not take longer than 4 hours. In addition, the costs of registration have been reduced to less than EUR 50. During the first half of 2008 5.200 new companies were registered, which is about 1% up on the same period in 2007. As a result, the number of registered companies grew by some 6% during the past year. As part of the so-called "regulatory guillotine" project, the authorities screened some 2000 pieces of legislation, eliminated redundant legislation and simplified a number of laws and by-laws. The average duration of bankruptcy procedures has fallen from 3 years and 7 months to 2 years and 2 months. At the same time, the number of new bankruptcy procedures has fallen by about half, compared to the same period a year ago. The backlog in bankruptcy cases has been reduced. Overall, some progress has been achieved in further reducing barriers to market entry and exit. However, there is still considerable room for improving the overall business environment.

Legal system

The law on the real estate cadastre has been amended, resulting in a strengthening of the institutional set-up and requiring a formal decision on a registration request within 15 working days. The registration of property rights has made good progress and now covers some 82% of the country's territory compared to 63% in September 2007. The authorities plan to finalise full registration by 2009. The backlog of unsolved property disputes has been reduced further, from some 9 000 unresolved property cases at the end of 2007 to 7 700 by July 2008. However, in general, legal procedures are still slow and this adversely affects legal certainty and impedes the proper functioning of market mechanisms. Regulatory and supervisory agencies have often lacked sufficient resources and independence to fulfil their role as guardians of the rule of law and providers of a level playing field for all economic agents. However, amendments made to the budget law in September have strengthened the financial independence of a number of those agencies. Overall, further progress has been made in clarifying property rights and strengthening the independence of regulatory and supervisory institutions. However, weaknesses in the judiciary, including slow procedures and insufficient resources, still hamper the rule of law, for example in the area of contract enforcement. In combination with slow progress in addressing corruption and organised crime, these weaknesses have a negative bearing on the quality of public services, the business environment and the country's attractiveness to foreign investment.

Financial sector development

Financial intermediation increased markedly in 2007. Total deposits of the non-financial private sector reached 47% of GDP, compared to 41% at end 2006. This sharp increase helped trigger a marked rise in bank lending to the private sector, which brought the credit-to-GDP ratio to 37% of GDP by end 2007, compared to 26% of GDP the previous year. In order to contain the rapid expansion of credit, the Central Bank increased the bank's reserve requirement by 1 percentage point. The capitalisation of stock and bond markets rose sharply in 2007, reaching 92% of GDP at end of 2007, but fell back again during 2008 to 56% in August. Bond markets followed a similar pattern, but at a lower level, achieving a market capitalisation of 12% of GDP, which dropped to 5% by August. The assets of the banking sector reached 66% of GDP at the end of 2007, compared to 57% a year before. The structure of the financial sector has improved: one small bank which did not meet the fit-and-proper standards has been closed and some foreign investors have entered the market. The share of State ownership in the sector continues to be low, amounting to some 5% of the sector's assets. The main State assets consist of a majority share in the country's only development bank and a limited number of remaining minority shares in other private banks. Despite a relatively large number of banks (18 banks and 12 savings houses), concentration in this sector is rather high, with the five largest banks accounting for some three quarters of the sector's assets and deposits. The efficiency of financial intermediation has increased, as indicated by a further decrease in spreads between lending and borrowing rates, from 4.6 percentage points at the end of 2007 to 4.0 percentage points in September 2008. Profitability in the sector was relatively high in 2007, with an average return-on-equity of 15.2%, compared to 12.3% in 2006. The return-on-assets remained at 1.8%, reflecting the strong asset growth, which occurred in 2007.

The stability of the sector has benefited from the legislation to implement the new banking law, which has raised regulatory standards and strengthened supervisory capacities. The exposure of the banking sector to non-performing loans (risk classes C, D and E) declined, and non-performing loans as a share of total loans dropped from 7.6% at end-2006 to 5.7% at end-2007. However, the share of loans with a foreign currency component increased from 52.7% end of 2006 to 54.7% end of 2007. The banking sector continues to be well capitalised, with an average capital adequacy ratio of 17% end of 2007. Larger banks report an average capital adequacy ratio of 12.7%, while small banks report an average capital adequacy ratio as high as 66.8%. Overall, the financial sector continued to develop positively during the past year, with a significant deepening of financial intermediation and a strengthening of regulatory and supervisory standards. However, this sector is still relatively small.

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

Existence of a functioning market economy

Overall, macroeconomic stability has been maintained, although a less favourable international environment prompted a sharp increase in inflation and a widening of external imbalances. Progress in reducing barriers to market entry and exit has been maintained and the number of unresolved property disputes has been further reduced. Financial intermediation has deepened and financial market supervision has been strengthened. The financial independence of some supervisory and regulatory agencies has been strengthened. However, despite important progress in improving the business environment, the still slow speed of judiciary procedures and sometimes insufficient resources of supervisory and regulatory agencies are still impeding the rule of law, contract enforcement and the creation of a level playing field for market participants, which are crucial elements for fully functioning markets.

Human and physical capital

The authorities increased their efforts to provide education to a greater number of pupils and to improve vocational training for adults. Budgetary allocations for education have been increased from around 3.5% of GDP in 2005 to nearly 5% in 2007. For 2008, budgetary allocations (including foreign donations) have been raised to nearly 6% of GDP. Spending for decentralised education and higher education saw the strongest increases. An important share of additional spending is devoted to the renovation and construction of school buildings. The number of teachers for primary and secondary schools has been increased by 1.5% and 2.5% in 2008. However, the efficiency of public spending on education and the quality of education still leaves room for improvement. Despite these efforts, the overall level of education and training of the labour force still is relatively low and a substantial mismatch still exists between the qualification profile of the labour force and the requirements of the enterprise sector. Overall, measures have been taken to improve the level of qualification, such as starting to improve vocational training. However, further efforts to reduce the mismatch with labour market demands are still needed.

The authorities have embarked on a number of measures to address unemployment. The scope of active labour market measures has been widened and steps have been taken to remove impediments to job creation. For example, work has started on modernising and simplifying the current system of social security financing. Nevertheless, unemployment has remained at a very high level. In particular, a considerable proportion of unemployment is structural and mainly affects young people and those lacking qualification. Overall, measures have been taken to improve the labour market situation, but the mismatch between supply and demand is still a sizeable one.

Overall, the country's capital endowment is relatively low and its quality has suffered from decades of underinvestment. Recently, domestic and foreign investment has started to increase. Some progress has been made in improving the electricity network and a number of roads in Corridor X. Inflows of

FDI have reached some 10% of GDP in the first half of 2008, compared to some 3% of GDP on average during the same period of the previous year. The main factors behind this increase were related to foreign investment in the banking sector, although there has also been some greenfield investment. In some cases, slow legal procedures and fragmentation of responsibilities between the central and local governments are impeding FDI. Overall, the share of investment in GDP remained relatively low, in particular in the light of the country's need to accelerate growth. Infrastructure continues to require repair and modernisation.

Sector and enterprise structure

The overall trend towards a larger contribution by manufacturing and trade services to output generation and the declining share of the agricultural sector has continued. Construction and real estate business were those sectors with the largest increase in the number of companies, while the share of manufacturing declined. Competition has been increased in the telecommunication and transport sector by allowing additional suppliers to enter the market. However, the latest take-over in the telecommunication sector raises doubts, whether competition has indeed increased in this sector. The number of new enterprises in the total economy has risen by some 6%. In 2006, small and medium-sized companies (SMEs) accounted for some 54.3% of GDP and 78.4% of employees. The informal sector remains large, although there are indications that it has been somewhat reduced, for example by improvements tax collection, a lowering of the tax burden, and financial incentives for registration. Overall, structural change made limited progress

State influence on competitiveness

Direct state influence on competitiveness has been limited. However, competition in product markets is often impeded by slow judicial procedures and weak regulatory and supervisory agencies that lack the necessary independence and resource endowment. Despite some progress in reducing distortions in the electricity sector, energy prices do not yet cover full costs, which lead to substantial losses of the State-owned energy providers and requires significant budgetary transfers. Overall, direct State influence on competitiveness is rather limited. A weak rule of law and weak institutions are not always able to create a level playing field for market participants. Indirect State aid still leads to distortions in relative prices, in particular in the electricity sector. Overall, direct state influence on competitiveness is limited. However, in some areas, such as electricity, indirect and direct state interference is still high. Furthermore, numerous ad-hoc changes to business legislation impede the predictability and reliability of the business environment.

Economic integration with the EU

The country has a small open economy, with total trade in goods and services accounting for some 130% of GDP. Trade integration with the EU is advanced, with about 60% of all exports being directed at the EU-27 and about 47% of imports coming from the EU-27. The neighbouring countries in the Western Balkan are the second most important trade destination, with about 34% of exports and about 11% of imports. The importance of CEFTA as an export destination has increased markedly. The export structure is still highly concentrated on a limited range of products, with textiles and clothing accounting for about 24% of total exports, and manufactured iron and zinc products for some 26%. Overall, trade integration with the EU is well advanced, but the commodity mix is still concentrated on a few price-sensitive products.

International price competitiveness has started to deteriorate. While the exchange rate against the euro has remained stable in nominal terms, the recent strong rise in prices has resulted in an increase of the real effective exchange rate. However, when unit labour costs are taken into account, real effective exchange rates are still improving. Real wage increases seem to have remained in line with productivity growth. Standard indicators do not point to any significant material changes in export price competitiveness.

2.4. CONCLUSIONS

The **economy** of the former Yugoslav Republic of Macedonia has maintained solid growth. However, the less favourable international economic environment contributed to a sharp deterioration in the external accounts and a rise in inflation. Progress with structural reforms has continued and business environment has been improved. However, the persistence of very high unemployment remains a major cause for concern. Institutional weaknesses and deficiencies in the rule of law continue to impede the smooth functioning of the market economy and have a negative bearing on the business climate.

As regards the **economic criteria**, the former Yugoslav Republic of Macedonia is well advanced. It has moved closer towards becoming a functioning market economy. It should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it vigorously implements its comprehensive reform programme in order to reduce significant structural weaknesses.

The country has maintained a broad political consensus on the essentials of economic policy. The policy mix remained largely in line with macroeconomic stability and predictability. The country's growth performance has remained solid. The quality of public finances was improved by reducing tax rates and increasing efficiency in tax collection as well as by increased spending for infrastructure and education. The relatively low level of public sector debt has been maintained. Improved tax collection points to some success in reducing the informal economy.

FDI inflows increased markedly during the last year. Privatisation is largely completed. The share of the private sector in total output accounts for about 80% of the value added. Price and trade liberalisation has been accomplished practically in all sectors. Bankruptcy procedures have been further shortened and property registration has been accelerated. Financial independence of supervisory and regulatory agencies has been somewhat strengthened. Financial intermediation has increased. Competition in the network industries has been improved. In addition, measures have been taken to improve the quality of human capital. Economic integration with the EU is well advanced.

However, the deterioration in the country's external balances has increased external vulnerabilities, making fiscal discipline even more important. Labour markets are still functioning poorly; very high unemployment rates persist. The functioning of the market economy is still hampered by institutional weaknesses and the need to strengthen the rule of law. Public administration remains inefficient and in some sectors the degree of legal certainty is still low, which has a negative bearing on the country’s attractiveness for foreign investment. The judiciary continues to be a bottleneck, and regulatory and supervisory agencies sometimes still lack the resources to function effectively.

Despite efforts to reduce the unregistered economy, the informal sector remained sizeable. It is fuelled by a weak regulatory framework, and by weaknesses in law enforcement, including the fight against corruption and organised crime. The informal sector remains an important challenge as it reduces the tax base and the efficiency of economic policies.

3. TURKEY

3.1. INTRODUCTION

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

3.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Turkey broadly implemented the economic policy agreed with the Commission and with international financial institutions and successfully completed the stand-by arrangement with the International Monetary Fund (IMF) in May 2008. The pre-accession economic programme submitted to the Commission in December 2007 adequately reflected the needs for, and commitments to, further reform. At times, the domestic political crisis hampered the decision-making process with regard to reforms. The fragmentation of responsibilities between government bodies has been partly addressed in the new government's programme by assigning the role of coordinating economic policy to a Deputy Prime Minister. However, coordination of budgeting and medium-term economic policy-making has so far only partially benefited. Decisions sometimes appear to be taken on an ad hoc basis and impact assessments are either lacking or based on partial information. In conclusion, consensus on economic policy essentials has been maintained and coordination has improved.

Macroeconomic stability

In 2007, GDP growth slowed down to 4.6% from 6.9% one year earlier, mainly due to contraction in agriculture and weaker aggregate demand. There was a slowdown or stagnation in many sectors of the economy from construction to textiles, while agriculture was severely hit by a drought. Private consumption growth remained weak in 2007 growing by 3.8%, in spite of a strong surge (up 6.3%) in the third quarter. The public sector purchased significantly lower volumes of goods and services and markedly reduced construction after sizeable spending increases in these areas in the run-up to the July 2007 elections. The contribution of the external sector to growth fell substantially, as imports grew by 14.4% and 15.7% year-on-year in the third and fourth quarters respectively, while export growth was 2.5% in the fourth quarter, down from 12.5% in the first quarter of 2007. The slowdown in domestic demand was triggered mainly by a tighter monetary stance, higher interest rates and lower lending.

In the first half of 2008, the economy slowed down, due to the global financial turbulence and the domestic political uncertainty, and GDP grew by 4.2%. GDP growth slowed down to 1.9% in the second quarter of 2008 from 6.7% in the first. Agriculture contracted by 3.5% in the second quarter after output had increased by 2.6% in the first quarter. Final consumption of households lost steam in the second quarter, as expenditure rose by 2.8% after a 7.6% increase in the first. In March 2008, the GDP methodology was aligned with the European System of Accounting (ESA95). Consequently, one third was added to the size of the economy, which resulted in a 2006 GDP of more than TRY 750bn (about EUR 380bn). Although economic growth has slowed down, due to a combination of weaker aggregate demand and higher uncertainty linked to the global financial crisis and domestic political developments, overall economic performance demonstrated that the foundations and resilience of the Turkish economy are substantially stronger today than some years ago.

The thorough revision of Turkey's national accounts in March 2008 reduced the current account deficit relative to GDP by one third to more benign levels. The sharp rise in oil prices has been putting pressure on Turkey's current account. This has become more pronounced in recent months as oil prices have soared to record levels. The current account deficit in the first half of 2008 totalled about 6.3% of GDP, compared with 5.7% in 2007 and 6.2% in 2006. The same indicator, excluding energy, was below 2.8% throughout the period. This pointed to a trade deficit of about 7% in the first half of 2008. As in previous years, over one third of the gap is covered by services, mainly tourism, which performed better in 2007 and 2008 than in 2006. On the capital account, capital inflows have more than funded the current account deficit, leading to an increase in official reserves. Recently almost 40% of the current account deficit has been financed by foreign direct investment (FDI) and the remainder by long-term inflows, comprising long-term external borrowing by the private corporate sector and banks. The share of portfolio investments declined significantly and became negative from March 2008 on. FDI inflows totalled 3% of GDP in 2007 and 2% in the first half of 2008. The services sector (mainly banks and telecommunications) accounted for almost two thirds of total FDI. Turkey's external debt rose by almost 20% in nominal terms to roughly 45% of GDP by mid-2008. Private external debt makes up two thirds of the total and is rising fast, which is a source of potential risk. International reserves increased by over 15% to EUR 47 billion, or about six months of imports. Although higher oil and commodities prices put pressure on Turkey's current account, long-term capital inflows remained high, leading to an increase in official reserves. Turkey's external position remained solid throughout 2007 and the first half of 2008.

So far (by mid-October 2008), the global financial crisis has caused a correction in Turkish asset prices and in the currency, which could also lead to further output losses and inflationary pressures. The impact on the Turkish banking system has remained limited so far, largely due to previous restructuring measures and comfortable prudential indicators. However, considerable external financing needs stemming from large external deficits in combination with the private sector's significant reliance on external financing and a sizeable - albeit falling - debt stock make Turkey potentially vulnerable to changes in investor sentiment. The quality of financing of the current account deficit has deteriorated, gradually moving away from equity investment towards debt accumulation. The close cooperation amongst Turkish financial authorities as well as with the international and European financial institutions, the existence of strong prudent regulations, the implementation of restrictive monetary and fiscal policies as well as the continuation of structural reforms are providing a stabilising effect to financial markets and the economy.

Labour market conditions remained challenging. The working-age population increased by over 700,000 in 2007. Fewer than 300,000 of them joined the workforce; the rest remained outside the labour market. Consequently, the employment rate hovered around 43% in 2007-2008. In particular, the female employment rate remained low at less than 24% of the total working-age population. The unemployment rate remains between 10% and 11%. Unemployment was much higher among the young (about 20%). Long-term unemployed accounted for more than half of job-seekers. Agriculture typically employs many unpaid family workers. This leads to a statistically lower rate of unemployment, but suggests large pockets of underemployment in this sector and the economy at large. Job creation continued to be hampered, in part, by labour market rigidities (for example, high severance payments and the sizeable social security wedge), by the skills mismatch between labour demand and supply and by the cost of hiring and firing. Overall, labour continues to act as a brake on employment.

Annual inflation rose to 8.4% by the end of 2007 and to 10.6% by mid-2008, well above the inflation target, partly due to soaring food and energy prices. Excluding unprocessed food and energy, underlying inflation rose to 10.4% in mid-2008, a four-year high, depreciated substantially vis-à-vis the euro in September and October 2008. The Central Bank maintained the formal inflation targeting policy adopted in January 2006, but chose to raise its inflation targets in June 2008 in an effort to anchor inflationary expectations more firmly. At the same time, the Central Bank decided to raise rates by a cumulative 150 base points, after having cut them by 225 base points in the course of 2007 and early 2008. It has also announced a tightening bias with the aim of fighting second-round effects on prices. This action was seen as a reaffirmation of the independence of the Central Bank and a strong signal of its continued commitment to fighting inflation. Credit to the private sector remained broadly constant on around 30% of GDP and is therefore not seen as a significant threat to price stability. In conclusion, price stability has weakened significantly over the last year, partly due to external factors.

Fiscal performance has been satisfactory, although the government missed its 2007 fiscal targets. Public debt (ESA95 definition) fell from 46.1% of GDP in 2006 to 38.8% in 2007 and is expected to continue to fall over the medium term, improving fiscal sustainability. The 2007 primary surplus – which excludes interest payments – equalled 3.5% of GDP (ESA95 methodology), down from 5.5% in 2006. In June 2008, the authorities announced the introduction of a five-year (2008-2012) medium-term fiscal framework (MTFF), which offers good visibility over the government's medium-term fiscal strategy. The MTFF seeks to reduce public debt from around 39% in 2007 to 30% in 2012. This is to be achieved by means of a primary surplus of 3.5% in 2008 (unchanged compared with 2007), declining to 2.4% in 2012. The overall deficit is projected to remain below 1.7% over the five-year period. The fiscal space gained from reducing debt service is to be used to finance three major policy initiatives: an employment package and social security reform, the South Anatolian project (mainly infrastructure investment) and decentralisation to municipalities. Fiscal targets for the first half of 2008 have been met, in large part due to the higher – mainly tax – revenue which kept pace with inflation.

The recent depreciation of the Turkish currency caused a limited decrease in government debt in the first few months of 2008. Recent interest-rate increases had much less impact on the debt stock, which increasingly comprises fixed-rate government securities. However, domestic financial markets remain relatively shallow and the debt service dynamics are still closely related to movements on global financial markets. The average maturity of government debt securities therefore fell in the first quarter of 2008 to 23.5 months, from 25.7 months in 2007. By mid- 2008, almost 60% of total government securities were in the hands of banks, up by almost 2% from 2007, and thus mitigating the decline in non-residents' share. Completion of the IMF stand-by agreement, combined with the perceived uncertainty regarding the future direction of economic policy and the protracted global financial crisis, call for stronger anchoring of the fiscal position. In addition to the MTFF, introduction of a robust and binding fiscal rule would substantially reduce uncertainty and the vulnerability of Turkey's public finances to further turbulence on the financial markets. Overall, fiscal sustainability has been further strengthened thanks to a prudent fiscal policy, but the fiscal position remains vulnerable to shocks and requires stronger anchors in the face of heightened uncertainty and the ongoing financial crisis.

In 2007, several coordination and control bodies were set up within the Ministry of Finance. Accountability, efficiency and transparency of the budgeting process have benefited substantially. This is illustrated, for example, by the development of the MTFF. As last year, some key elements are still lacking, in particular unifying all tax administration functions under the Revenue Administration, strengthening audit capacity and making increased use of standard risk-based audit techniques, which would all enhance transparency and provide significant support for anti-corruption efforts. Overall, measures to increase fiscal transparency have continued.

Over the last few years, Turkey has successfully implemented a strong stabilisation programme. Now it is entering a new stage in its development strategy aimed at raising the growth potential by means of higher public investment, job creation, structural reforms and better education. This entails a difficult balancing act between the desire for higher growth and the need to maintain price stability and reduce the current account deficit. While the public debt level is no longer a major concern for fiscal sustainability and the current policy mix is broadly adequate, macroeconomic stability remains vulnerable to shocks, given the wide external imbalances. Interplay of market forces

The independence of regulatory and surveillance agencies has been largely preserved, although some imperfections persist. However, for the first time in several years significant progress was made, in particular in the area of price liberalisation. Electricity and gas prices were raised in January and June 2008 respectively to reflect the actual costs better. Since July 2008, electricity prices are subject to automatic indexation. Price subsidies are being phased out with a view to privatising some public electricity companies by the end of 2008. Administrated prices make up less than 10% of the total weight of the consumer price index (CPI) basket.

Despite its stated intention to allow State-owned firms to set their own prices, the government continued to set prices of goods produced by them. The prices of some key commodities produced by the State are periodically raised. In general, the government sets annual prices for a range of crops. The municipalities continue to place ceilings on the retail price of bread and the Ministry of Health controls medicine prices. Permission for price increases has traditionally depended more on political than on economic criteria. Public institutions and local authorities have large arrears with the State-owned energy company. Price liberalisation is fairly advanced and further progress has been made recently. However, the government continues to control the prices of some key commodities.

Although privatisation continued, with a number of major operations, the private sector's share of GDP remained virtually constant at almost 89% in mid-2008. The pace of privatisation slowed down only slightly from the peak years of 2005-2006. Between July 2007 and mid-2008, privatisation proceeds totalled about EUR 5 billion. Major privatisations included the sales of the petrochemicals company Petkim (EUR 1.4 billion), the State railways port facility in Izmir (EUR 0.8 billion) and of the State tobacco company TEKEL (EUR 1.2 billion) and the initial public offering of 15% of the shares in Türk Telekom (EUR 1.3 billion). In conclusion, privatisation has advanced significantly.

Market entry and exit

Turkey has made efforts to improve the business climate and reduce impediments to market entry and exit. Appreciation for this has been voiced by international experts. The business registration process was further streamlined in 2007. Legal changes were enacted to make it easier to obtain business and operating licences, including in the mining sector. About 55,000 new companies were established in 2007, an increase of 5% compared with 2006. During the same period, roughly 10,000 firms were liquidated. Sectoral restrictions on foreign ownership continued in the areas of maritime transport, civil aviation, groundhandling, road transport, radio and TV broadcasting, energy, accountancy and education. Entry to the banking and capital markets remained restricted to mergers and acquisitions as no new licences have been issued. Overall, some progress can be reported in business entry and exit.

Legal system

A reasonably well functioning legal system, including in the area of property rights, has been in place for several years. However, no major progress has been made over the last year. Registering a property takes six procedures and six days in Turkey. Enforcing commercial contracts remains a lengthy process, which needs 36 procedures and takes 420 days on average. The specialisation of commercial court judges appears insufficient, leading to lengthy court proceedings. The expert witness system continues to function as a parallel judiciary system, without improving the overall quality. Use of out-of-court dispute-settlement mechanisms remains low. The legal environment continues to pose practical challenges and creates an obstacle to a better business environment.

Financial sector development

The financial sector grew steadily in 2007 and 2008 and attracted sizeable foreign investments. The total assets of the financial sector grew by 18% in 2007 and at a similar pace in early 2008. Almost 90% of these assets belong to banks. The ratio between the banking sector's balance sheet and GDP increased to almost 68% at the end of 2007 compared with 66% a year earlier. The ratio of deposits and loans to GDP increased by 3% and 15% respectively in 2007, which demonstrates the continuing financial deepening and increasing intermediation, channelling more savings into productive investment. The efficiency of financial intermediation improved slightly, as the interest rate spread narrowed by about 0.2% in the previous year. The banking sector attracted strong interest from foreign investors. Consequently, foreign shareholders' share of the sector's assets grew to 26% by the first quarter of 2008 from 22% in early 2007. Including shares listed at the stock exchange, almost 45% of the Turkish banking sector is owned by foreigners.

The Central Bank made significant efforts to monitor developments in the financial sector more closely. Liquidity requirements were tightened and a new survey was launched to monitor better both private-sector debt and the exposure of the corporate sector to exchange rate volatility. The delay in adoption of the new Turkish Commercial Code is hampering the Central Bank's risk assessment capacity, since financial statements have not been aligned with international financial reporting standards. More broadly, adoption of the new Commercial Code is a priority, as it would significantly improve the business environment. Banking profitability ratios improved markedly, by about one third in the year to December 2007. Capital adequacy ratios decreased significantly, albeit from very high levels, from 21.8% in 2006 to 17.3% by March 2008. Concentration in the banking sector is at the same level as last year, as the five largest credit institutions' share of the banking system remained at 60% at the end of 2007. In April 2008, the Banking Regulation and Supervision Agency (BRSA) increased the liquidity requirements for banks in order to mitigate the increased risk stemming from the corporate sector's growing foreign exchange borrowing. The net liabilities of the non-bank corporate sector in foreign denominations increased by 60% in the year to December 2007 to about EUR 45 billion (12% of GDP). The share of foreign exchange-denominated corporate loans as a percentage of the banking sector's total loans fell from almost two thirds at the end of 2006 to just 56% in early 2008. In spite of several bouts of instability during 2007-2008 the financial sector has shown remarkable resilience.

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

Existence of a functioning market economy

Macroeconomic stability has been broadly preserved during the reporting period. Financial market turbulence and domestic political developments added some uncertainty to the business environment, but at the same time underlined the economy's improved shock resilience so far. The authorities have improved the investment climate by reducing administrative barriers to firms' entry and operation, by reducing and simplifying the tax system while improving the effectiveness of the tax administration and corporate governance and by privatising State-owned enterprises.

Human and physical capital

In 2007-2008, the authorities continued to implement the educational reform programme, which is part of the National Development Plan (2007-2013). This programme has two key pillars for education: modernisation and reform. On the one hand, it aims to increase the responsiveness of education to demand and, on the other, to enhance the educational system. The challenges are significant. The top students in Turkey perform well. However, the gap with the vast majority of Turkish students remains significant. Participation in higher education remains low by international standards. Around 40% of 20- to 24-year-olds had completed secondary education, but about ten percent of school-age children are still not enrolled in primary schools. Reforms and increased spending on education are having some positive impact on educational attainment. In 2007, enrolment rates improved at all levels of education, in particular for female students, but significant problems persist.

Little progress has been made on correcting the mismatch between supply and demand forces on labour markets, which largely stem from the sectoral shift away from agriculture combined with often inadequate education. Coverage of the population eligible for unemployment benefit is limited by rigid eligibility conditions. In May 2008 the government adopted a new employment package, which provides incentives to employ young workers, women and people with disabilities. The package aims to reduce non-financial burdens and social security contributions, which had acted as a disincentive to formal employment. In particular, the package reduces employment costs for five years for newly employed people in the above-mentioned categories. However, it does not affect other barriers which complicate job creation, for example the very high severance payments. The Turkish Employment Agency continued its efforts to improve its institutional capacity and the services provided to job-seekers. Turkey declared 2008 the year for combating undeclared work. Overall, the situation on the labour market remains challenging, but a set of broadly adequate reforms have been tabled.

Both domestic and foreign investments remain robust. Private gross fixed capital formation grew by around 5% in 2007 and in the first half of 2008. Private capital formation totalled around 17% of nominal GDP. FDI inflows decreased to 3% of GDP in 2007 and 2% of GDP in the first half of 2008. Around 80% of these FDI inflows were equity investment and around 20% real estate purchases. As a result, the FDI stock stood at EUR 53.7 billion (about 15% of GDP), of which about one quarter was due to 2007 inflows. Most of the equity investments in 2007 were in financial services (60%) and manufacturing (20%). Investment growth weakened, albeit from very high levels.

For many years infrastructure investment has been hampered by the need to consolidate public finances and the failure to cut lower-priority spending. Inadequate infrastructure is increasingly affecting economic activity. Therefore, the government adopted a spending programme, which aims at releasing about TRY 17 billion (EUR 8.7 billion) for investment in infrastructure in the South-eastern Anatolia region between 2008 and 2012. In addition, extra power-generating capacity is planned in order to keep pace with the rapidly growing electricity consumption (7% on average in each of the past five years). The new government's initiatives aim at boosting investment in infrastructure. Also, the EBRD shareholders have recently decided that the Bank should start operating in Turkey, a decision that was supported by the Commission and the EU shareholders. The EBRD's support will contribute to Turkey's further development and reform programme. The EBRD can support the development of a more open and entrepreneurial economy by promoting growth of small businesses, supporting the Turkish government's privatisation programme, bringing private sector financing and know-how to the provision of public services.

Sectoral and enterprise structure

The share of agriculture in employment fell by about 1 percentage point to 26.5% in 2007. Most jobs were created in the services sector. The share of services in the total labour force rose to 48%. Employment in industry and construction accounted for roughly 20% and 6% respectively. The relative size of agriculture in GDP fell from 8.3% in 2006 to 7.7% in 2007. Industry's (including construction) contribution to GDP remained stable at roughly 31%, while services generate about 60% of national income. The sectoral shift away from agriculture towards services has continued.

SMEs account for 99% of all enterprises in Turkey and 77% of total employment. However, SME ratios for capital investment (38% of the total), value added (26.5%), exports (10%) and bank credit (5%) point to low labour productivity, insufficient access to finance and barriers to entering foreign markets. Informality is widespread throughout all corporate sectors, but particularly amongst SMEs. Small enterprises continue to suffer from insufficient managerial capacity and a too small knowledge base to cope with the increasing competition on the markets. To sum up, SMEs continue to have insufficient access to finance and know-how and too often operate in the grey economy.

Restructuring was supported by privatisation in some areas, such as telecommunications. Progress has been made on restructuring and preparing for privatisation in the energy sector, where the main outstanding problems are related to cross-subsidies and large distribution losses. In the private sector, strong productivity gains indicate that the restructuring process has been largely successful. Overall, the process of structural transformation of the economy has advanced relatively well, mainly in the form of privatisation.

State influence on competitiveness

Transparency in the corporate sector has improved and accounting standards have been upgraded, although the new Commercial Code has not yet been adopted. The absence of transparent monitoring of State aid and of supporting policies to reduce distortion has an adverse effect on competition and competitiveness in the economy. Public procurement policies continue to be undermined by exceptions to the regulatory framework. In addition, a number of derogations have been introduced by sectoral laws, which has further limited the scope of the law. Overall, State intervention continues to influence competition and competitiveness considerably, although the State's role as an active player on the markets is being further reduced.

Economic integration with the EU

Turkey's trade openness has increased marginally. Exports and imports of goods and services totalled 60% of GDP in 2007. The share of exports to the EU increased slightly from 56.0% in 2006 to 56.4% in 2007. Imports from the EU as a share of total imports declined, from 42.6% to 40.4%, mainly due to the rising import bill for energy, which Turkey imported almost exclusively from non-EU countries. Investors from EU Member States continued to invest heavily in Turkey, though at a slower pace. About two thirds of all FDI inflows recorded in 2007 originated from EU Member States, down from 82% in 2006. In the first quarter of 2008, the share of FDI flows from the EU fell further to 53%. In 2007, GDP per capita in Turkey stood at 43.3% of the EU-27 average. The EU remains Turkey's largest trading and investment partner.

3.4. CONCLUSIONS

The **economy** of Turkey continued to perform relatively well, although growth fell below potential largely owing to a slowdown in domestic demand following severe monetary policy tightening. Macroeconomic stability has been preserved. Inflation has increased significantly, mainly as a result of higher food and energy prices. The structural reform process has accelerated somewhat, in particular in the first half of 2008. Despite some recent initiatives, further progress is necessary to correct labour market imbalances and address the skills mismatch.

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

Over the past year, Turkey has implemented a strong stabilisation programme. Now it is entering a new stage in its development strategy aimed at raising its growth potential through higher public investment, job creation and sectoral reforms. The economy has so far performed well in spite of the global financial turbulence and the domestic political uncertainty.

Long-term capital inflows remained high, leading to an increase in official reserves. Fiscal performance has been satisfactory, although the government missed the 2007 fiscal targets. In June 2008, the authorities approved a 5-year Medium Term Fiscal Framework.

New initiatives to boost investment in infrastructure are aiming to reduce the very high regional disparities. Significant progress was made in the area of price liberalisation, particularly in the energy sector. Privatisation continued with a number of major operations. In spite of several bouts of instability during 2007-2008, the financial sector has so far shown remarkable resilience.

However, inflationary pressures have increased, in part due to higher oil and commodity prices. Considerable external financing needs stemming from large external deficits, coupled with the private sector's significant reliance on external financing and a sizeable - albeit falling - debt stock, make Turkey potentially vulnerable to changes in investor sentiment. Job creation continues to be hampered, notably by a skills mismatch between labour demand and supply and by rigid employment practices. Structural rigidities in the labour market particularly hinder any increase in female and youth employment. The skills of the labour force are still not adapted to the needs of a rapidly growing emerging economy. Allocation of state aid lacks transparency. The large informal sector, fuelled by weaknesses in the regulatory framework, inappropriate tax and expenditure policies and weak law enforcement, reduces the tax base and the efficiency of economic policies. In particular, too often SMEs operate in the grey economy and therefore continue to have insufficient access to finance and know-how.

4. ALBANIA

4.1. INTRODUCTION

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

4.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The government submitted the Economic and Fiscal Programme for 2007–2010 in December 2007, setting out a coherent framework for the government's economic policies. The policies continued to support the establishment of a functioning market economy, but suffered in some cases from the lack of detailed action plans. The economic strategies were broadly consistent with the current International Monetary Fund three-year 2006–2009 PRGF/EFF programme in the country. In 2008, the government supplemented the longer-term strategy framework, adopting the National Strategy for Development and Integration (NSDI) for 2007–2013, prepared in consultation with domestic and international stakeholders. In line with the Integrated Planning System (IPS) the government also adopted the Fiscal and Macroeconomic Framework 2009–2011 and the Medium-Term Budget Programme 2008–2010. Overall, political consensus on the fundamentals of market-oriented economic policies was strengthened, but planning at too general a level sometimes presented a risk for the implementation of economic reforms.

Macroeconomic stability

The economy experienced strong growth despite a severe drought in the summer of 2007 and continuous electricity shortages. Extensive investments and high consumption led to a 6% growth in real terms in 2007 – the highest since 2002. Economic activity was fuelled by a robust, though slowing credit growth and continuing large-scale remittances inflows (12% of GDP). Unreliable electricity supply continued to pose a heightened risk to sustainable economic growth. The average per capita income in 2007 was around 22% of the EU27 average , up from 21% in 2006. Overall, economic growth remained strong and speeded up, while the general income level remained low.

External balances deteriorated, resulting in a current account deficit of 10.6% of GDP in 2007 - up from 6.5% in 2006. The deficit widened, mainly due to an increase in the merchandise trade deficit (26.8% of GDP in 2007), in spite of strong growth in exports. Higher energy imports (30% of the total increase in imports in 2007), resulting from a severe domestic drought, and demand for machinery contributed strongly to the increase in imports. Merchandise exports remained more than 3.5 times lower than imports, despite a strong increase in mineral exports. The trade deficit continued to deepen in the first half of 2008 due to high imports. The surplus in services trade remained limited and surpluses of income flows and other transfers (including remittances) were lower (relative to GDP) than in the previous year. Overall, external imbalances remained high and continued to widen.

Net capital inflows increased, covering the current account deficit in 2007. Net foreign direct investment reached 5.9% of GDP in 2007 (up from 3.5% in 2006), with strong inflows from a large-scale privatisation in the telecommunication sector. Other capital inflows (mainly foreign borrowing by the private sector and non-residents' deposits) rose, reaching 3.2% of GDP in 2007. However, from the fourth quarter of 2007 onwards the current account deficit exceeded net capital inflows, leading to a decrease in reserve assets. The stock of reserve assets stayed at the level of 3.3 months of imports of goods and services at end-June 2008. The external debt to GDP ratio fell to 24.8% at end-2007 (down from 25.1% in 2006), with the public external debt ratio falling to 15.4% of GDP. The financial sector external debt increased strongly (by 50%) due to short-term loans and non-residents' deposits. Corporate sector foreign borrowing remained limited (with stock falling below 5% of GDP). In total, net capital inflows increased, but remained relatively low.

The recent turmoil in the global financial markets increased risks to the Albanian economy. The risks to the financial sector are mitigated by the overall low level of financial intermediation and a limited integration to the international capital markets, while the banking sector is well capitalised and mainly financed by households' deposits. However, the continuous widening of the current account deficit requires increasing capital inflows that might be inhibited by the expected global economic slow-down.

Labour market conditions improved in 2007. The number of registered unemployed decreased, resulting in a drop in the unemployment rate (13.4% in 2007 and 13% in March 2008 - down from 13.9% in 2006). The number of employed persons increased as a result of higher employment in the non-agricultural private sector. In total, the labour force (the sum of employed and unemployed) decreased by around 0.4%, indicating some movement of unemployed persons to inactivity. Wages in the public sector increased by 17.1% on average in 2007, significantly more than in 2006 (7.5%), but did not add significantly to domestic demand pressures on inflation. Overall, the labour market performance slightly improved, but rigidities remained relatively high. However, due to the significant informal economy, labour market data may not correctly reflect the actual dynamics of the labour market.

The central bank continued to implement a policy of implicit inflation targeting and an independent float. The objective of maintaining consumer price inflation at 3% with a fluctuation band of ±1 percentage point was met, with inflation averaging 2.9% in 2007. Potential demand pressures and pressures due to price increases in the global commodities markets were addressed by raising the key monetary policy interest rate. In the second half of 2007, the central bank raised the policy rate three times (cumulatively by 0.75 percentage points to 6.25%). In the first three quarters of 2008, inflation remained within the target range (measured as a 12-month average annual inflation), although in some months it exceeded 4% (year-on-year). The main contributors to annual inflation were food and energy prices, with the increase in food prices accounting for up to two thirds of annual inflation. The impact of domestic demand pressures was limited, despite a strong (though decelerating) credit growth and extensive remittances inflows. The increase in money supply (M3) remained relatively high (14% year-on-year in July 2008). Exchange rate fluctuations against the euro remained limited, with some temporary small-scale depreciation in March 2008. Overall, monetary policy remained sound, maintaining price stability.

The fiscal stance loosened somewhat in 2007, despite a strengthening of economic growth. Fiscal balances deteriorated, with the general government deficit increasing to 3.5% of GDP in 2007 – up from 3.3% in 2006. Fiscal policy remained expansionary, with the budget plans projecting even higher deficits, mainly due to plans for high public investment. However, strong economic growth made it possible to reduce the public sector indebtedness (as a ratio of GDP), despite a delayed fiscal consolidation. The public debt ratio fell to 53% at end-2007 from 56% in 2006, with domestic public debt falling to 37.6% of GDP. The management of public finances improved, especially in 2008, supported by large-scale tax administration measures that also contributed to the extension of the tax base. The introduction of a 10% flat personal income tax was accompanied by an increase in income tax revenues. The management of local government finances remained poor, resulting in low revenue collection and limited spending. Public spending followed the strategic priorities of higher public investments, keeping the increase in current expenditures constrained. Personnel expenditures were maintained at 6% of GDP, and interest expenditures were reduced to 2.6% of GDP in 2007, partly as a result of more efficient debt management. Government investments increased to 5.8% of GDP, but weak implementation kept capital expenditures significantly below projections. Regarding fiscal strategies, the 2008 budget projected a sharp deterioration of fiscal balances with a fiscal deficit of 7.9% of GDP, due to extensive capital expenditures amounting to 9.8% of GDP. A mid-2008 budget revision reduced the deficit projection to 5.2% by increasing revenue projections and cutting public investments. On the revenue side, the reduction of corporate profit tax from 20% to 10% in January 2008 brought about a change in the public revenue structure. Corporate tax revenues decreased, compensated by an increase in excise duties. Overall, the administration of public finances improved, but the fiscal stance loosened owing to ambitious public investment plans.

The macroeconomic policy mix was broadly adequate, with an increased emphasis on structural reforms. Monetary policy remained sound, while fiscal strategies prioritised higher public investments over further fiscal consolidation. Widening fiscal imbalances may lead to instabilities and prevent fiscal policies from playing their role. Vulnerabilities of external balances increased, requiring swift measures to ensure electricity supply, the broadening of the export base and a more attractive investment environment.

Interplay of market forces

State participation in the economy remained limited, with the private sector accounting for around 80% of GDP. The share of the employed in the private sector increased slightly to 82.1% in 2007 (up from 81.9% in 2006). Public enterprises continued to be mainly in the services and agricultural sectors. The privatisation of large-scale enterprises advanced significantly. The contract to sell an 85% stake in the ARMO oil refinery was approved and the privatisation of 76% of the shares of the distribution arm of the loss-making power corporation (KESH) is in progress. The government also concluded tenders on consultancy for the privatisation of its 12.6% share of the mobile telephone operator AMC, and of a majority of the insurance company INSIG. Privatisation of Albpetrol – the company involved in oil prospecting, research and development, and production – was delayed. Overall, the reduction of state ownership in the economy progressed, while the remaining inefficient large-scale state corporations continued to contribute to market distortions.

Market entry and exit

The government simplified business registration procedures significantly. The introduction of the National Registration Centre (NRC) reduced the time required to register a business to one day and provided for simultaneous registration for the purposes of tax administration, social and health insurance, and the Labour Inspectorate. Registration fees were reduced to less than one euro. The infrastructure for business registration services was improved by increasing the number of electronic services and registration centres across the country. The improved services framework, together with more rigorous inspections by the authorities, addressed ways for reducing the widespread informality of business. The simplified procedures allowed for a significant increase in the number of initial registration of businesses. The government also continued with the regulatory reform of licences by simplifying licensing procedures and reducing the number of licences. However, there is still scope for further simplification. Significant problems remained regarding the issuance of construction permits, which showed a sharp 40% drop in 2007. Regarding market exit procedures, the new law on bankruptcy procedures was approved in May; this provided a more efficient framework for business exit, as no bankruptcy proceedings had been concluded in the courts in recent years. Overall, administrative procedures for the establishment of businesses were simplified considerably. However, there remains room for further improvements.

Legal system

The government took a number of steps to strengthen the judicial system and the fight against corruption. A number of electronic public services (including the electronic public procurement system) were introduced in order to increase transparency. The general judiciary reform continued, with the adoption of a law on the organisation and functioning of the judiciary. Inspections of courts and public agencies were stepped up and legal procedures were initiated against officials responsible for violations. Legal certainty was increased by establishing a legal basis for a new type of administrative courts to rule on commercial cases and disputes between companies and public institutions. Preparations for defining property rights made progress. Offices in several cadastral areas were prepared for the initial registration of land, and preparatory work on the digitisation of maps of the territory was completed. However, further efforts are required to effectively fight against corruption that affects the business climate and has an adverse impact on the quality of public services. Overall, the legal framework for contract enforcement was strengthened, but the judiciary remained weak and uncertainty about real estate property rights persists.

Financial sector development

Financial intermediation expanded significantly, but its level remained low. Bank lending to the private sector rose to 31.4% of GDP in June 2008 (up from 21.4% at end-2006), while money supply (M3) remained above 70% of GDP. The share of other financial intermediaries remained low; no domestic companies were listed on the Tirana Stock Exchange and no progress was made regarding private pension funds. The adoption of the law on securities in March 2008 provides some basis for the development of the capital market. Insurance companies continued to be the other main intermediaries in the financial sector, with total assets of close to 2% of GDP. The banking sector is wholly owned by the private sector, and foreign capital participation recently increased to almost 99%. Following a merger, the number of banks was reduced to 16. Competition in the banking sector increased, while the concentration of assets declined. Profit rates of banks remained relatively strong (return on assets was 1.3% in June 2008, comparable to that of at end-2006). Banks continued to widen their range of lending products and increased the number of regional offices. Overall, financial intermediation, dominated by the well-functioning banking sector, continued to increase at a rapid pace, while the role of the non-bank financial sector remained limited.

The stability of the financial sector remained satisfactory, supported by a favourable economic environment and strengthened financial supervision. Capital adequacy remained on average far above the minimum requirement (with ratios of 17.3% and 12%, respectively, in June 2008), albeit somewhat lower than at end-2006. The quality of credit remained relatively high and the share of non-performing loans in total loans remained low, although it increased to close to 4% in March 2008 (up from 3.1% at end-2006). Strong - albeit slowing - credit growth and the fact that a large share of credit is denominated in foreign currencies are factors which demand careful handling of credit risks. The establishment of the credit registry brought additional transparency to the banking system. Overall, the financial system remained sound, addressing the growing risks of a possible deterioration of credit quality.

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

Existence of a functioning market economy

Macroeconomic stability was broadly maintained, providing economic agents with a supportive environment for decision-making. The functioning of market mechanisms still remained seriously distorted by unreliable energy supply, weak judiciary, uncertainty about real estate property rights and the inefficiencies still present in the regulatory framework for businesses.

Human and physical capital

The reforms to improve the quality of labour force continued, with a strong emphasis on vocational training. The government adopted a strategy on employment and vocational training, aimed at bringing unemployment down to the average level of the EU countries by 2013. In parallel, the National Council of Pre-University Education was established, and new guidelines for secondary schools and standards for post-graduate programmes were introduced. In total, public spending on education rose to 3.3% of GDP in 2007 (from 2.9% in 2006). To promote employment, the government introduced a partial compensation of training costs and a temporary compensation of social insurance contributions for companies that hire unemployed job-seekers. Proper assessments of the impact of the measures on the labour market continue to be constrained by limited and partly inconsistent labour market statistics. Overall, opportunities were created for increasing the relatively low quality of human capital, but their effects on the labour market remained unclear.

Physical capital accumulation continued at a rate comparable to 2006, although slower than in earlier years. The ratio of total investments to GDP was 29.2% in 2007. Public investments focused on the energy sector and on road construction. Net foreign direct investment (FDI) inflows increased significantly (to 5.9% of GDP in 2007), mainly owing to strong inflows from large-scale privatisation in the telecommunication sector. FDI inflows were also significant in the financial sector. The total stock of FDI remained relatively low, reaching 19.1% of GDP in 2007. Infrastructure remained poor despite significant investment in the road network. Preparations for reconstruction of railways and ports progressed. The hydro-power based electricity sector continues to lack the capacity to meet domestic demand. The number of concession agreements for building small-scale hydro-power plants has increased and the construction of a thermal power plant has begun. However, these measures will provide only a partial solution to the electricity shortages. Overall, capital accumulation continued, but capital stock remained limited.

Sector and enterprise structure

Enterprise restructuring continued in the remaining sectors under state ownership, largely as part of the preparations for privatisation. In the oil production sector, the restructuring of the ARMO oil refinery and the oil producer Albpetrol made progress and an investment plan for the oil refinery was submitted to the government as an obligatory document for the tender procedures. In the electricity sector, preparations for the restructuring and privatisation of the loss-making power corporation (KESH) made progress. However, electricity tariffs remained below cost-recovery levels, thus contributing to financial losses. Electricity supply remained unreliable. Overall, restructuring of enterprises progressed, but major additional changes are needed in order to increase the competitiveness of the current or former large-scale state monopolies.

The sectoral structure of the economy remained broadly unchanged, with the largest production being in the services sector. The mining sector contributed significantly to the increase in total production and exports, although its share of total production stayed relatively low. The agricultural sector remained the biggest employer, with 58% of total employed, but contributing only 20.7% of the GDP (for details see statistical annex). The informal sector remains large. Overall, the economy broadly maintained its structure, with considerable scope for further expansion of the services and industrial sectors, at the expense of inefficient agriculture.

State influence on competitiveness

The government kept the transfer of subsidies from the central budget at a relatively low level (0.4% of GDP in 2007). Electricity tariffs, set by a regulatory State authority, remained below cost-recovery levels, creating indirect subsidies to consumers. The recent sharp increase in global fuel prices triggered an exemption from the excise duty on fuels for producers in the agricultural and industrial sectors, as well as for certain energy producers. Overall, distortions of competition arising from state interventions were kept within bounds, while the energy sector issues remained unsolved.

Economic integration with the EU

The openness of the economy increased considerably, with total foreign trade in goods and services reaching 81% of GDP in 2007 (compared to 72% in 2006). Trade increased mainly due to an increase in imports, while competitiveness in exports remained weak (with exports of goods accounting for 10% and exports of services for 18% of GDP in 2007). The EU continued to be the main trading partner, while the share of the trade in goods with the EU declined slightly to 64% (down from 69%). The decline was partly the result of increased trade with CEFTA countries, but mainly due to a strong increase in exports of mining products to Asia. The country's weak competitiveness in trade with the EU continues to be reflected in a very high concentration of export partners (more than two thirds of total exports of goods are destined for one country, namely Italy). Imports (also in terms of trading partners) continued to show a considerably more mixed picture, with two main trade partners accounting for less than 50% of total imports. Overall, the EU continued to be the main partner in international economic relations, while overall international integration remained limited.

4.4. CONCLUSIONS

The **economy** of Albania continued to grow at a relatively fast pace. Inflationary pressures were contained, but external imbalances widened and the fiscal stance loosened. Macroeconomic stability was broadly maintained, supported by a wide range of structural reforms. The business environment improved. However, unreliable energy supply, poor infrastructure, and weak rule of law and contract enforcement continued to hinder economic development.

As regards the **economic criteria**, Albania made further progress towards establishing a functioning market economy. A continuation of structural reforms and sizeable investment in infrastructure and education are needed in order to enable the economy to cope with competitive pressures and market forces within the Union over the long term.

Political consensus on the fundamentals of market-oriented economic policies and macroeconomic stability has been maintained. The economy coped well with strong pressures from rising global food prices, and achieved an improvement in the labour market performance. The administration of public finances improved, resulting in higher tax revenues. Privatisation of large-scale state-owned companies progressed and business registration procedures were extensively simplified.

Measures were taken to improve labour force skills and to promote investments in infrastructure and enterprise restructuring progressed. The government intensified its fight against corruption and tax evasion. The financial sector remained sound, with increasing transparency in the credit market. State-induced distortions of competition remained limited.

However, macroeconomic risks increased as the current account deficit widened, mainly driven by increased demand for energy and machinery imports. Exports remained limited, and were well below the level of imports. On the financing side, capital inflows remained relatively small. A delayed fiscal consolidation also contributed to the existing aggregate savings-investment gap, given the increases in public investments in infrastructure. The unfinished restructuring of the loss-making state-owned power corporation remained a fiscal risk.

Unreliable energy supply continued to hinder economic development. The competitiveness of the economy remained hampered by shortages of qualified staff and a limited capital stock, including poor infrastructure. Employment in the agricultural sector remained unproportionally high. The large informal sector is fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement, including the fight against corruption and organised crime. The informal sector remains an important challenge, as it reduces the tax base and the efficiency of economic policies.

5. BOSNIA AND HERZEGOVIA

5.1. INTRODUCTION

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

5.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In December 2007, the government submitted its second Economic and Fiscal Programme for 2008-2010, which aims to consolidate the fiscal position and to improve the quality of public finances, inter alia by reducing the share of public spending in GDP. To a large extent, however, the objectives are not backed by concrete policy measures and the budgets adopted for 2008 do not fully reflect the scenario described above. Progress was made by reaching consensus on the fundamentals of economic policy and inter-entity cooperation in a number of important areas. In particular, a commitment was made to improve fiscal coordination through the adoption of the law on the National Fiscal Council and the inauguration of the Council in early September. Also, the Governing Board of the Indirect Taxation Authority agreed on a methodology for the coefficient to determine the allocation of indirect tax revenues. Direct taxes were reduced and legislative measures were taken to avoid double taxation in Bosnia and Herzegovina (BiH), albeit the latter remains an issue with regards to the Brčko District. On the other hand, in the Federation of Bosnia and Herzegovina (Federation) the commitment to pursue structural reforms has remained weak and the quality of public spending has actually deteriorated. Overall, political consensus on market-based economic policy was maintained. Inter-entity consensus on cooperation in certain economic policy areas improved, but the commitment to structural reforms and sound public finances remained uneven across the country.

Macroeconomic stability

Real GDP growth remained high at 6.8% in 2007, close to the 6.7% recorded in 2006. Economic growth in 2007 was driven by a strong increase in domestic demand, as evidenced inter alia by a widening of the current account deficit and a pick-up in core inflation (excluding food and energy prices). The acceleration of domestic lending together with fiscal relaxation fuelled economic growth by stimulating both consumption and investment. The good economic performance was achieved against a background of unfavourable domestic and external conditions, namely: a drought that affected agricultural output and the production of electricity from hydro-power plants, the evolving international financial crisis, the increase in international energy and food prices and volatility of the price of aluminium. As a result, gross value added was almost flat in real terms in the agriculture and utilities sectors, detracting from the double-digit growth rates recorded in financial intermediation, construction and manufacturing.

Growth in industrial output more than halved in 2007 compared to 2006 in the entire country and was close to stagnation in the Republika Srpska (RS). The growth of industrial production in the Federation slowed from 10.4% in 2006 to 8.6% and declined significantly to 1.4% in the RS following a record level of 19.1% in 2006. The slowdown in the RS was primarily due to the overhaul of production capacities in the mining and oil industry and declining output in the utilities sector, while the manufacturing sector moved ahead by 4.1%. Also in the Federation, utilities underperformed in 2007, but output growth rates in manufacturing and mining were strong at 11.7% and 5.6%, respectively. In the first eight months of 2008, the year-on-year growth of industrial production stood at 5.4% in the Federation and 8.4% in the RS. In both entities, energy production recovered and even outstripped the processing industry whose output increased by only 5.6% in the Federation and 2.6% in the RS. The shift towards higher value-added activities remains sluggish in both entities. There has been only a modest improvement in the quality of statistical information. The per capita income of Bosnia and Herzegovina, measured in purchasing power standards (PPS), was 26% of the EU-27 average in 2006 and increased by around two percentage points in 2007. Overall, economic growth in 2007 remained fairly high.

After narrowing temporarily to 8.4% of GDP in 2006, the current account deficit widened again to 12.7% of GDP in 2007. This development reflects the adverse effect of global food and energy prices on BiH's imports and the large swings in import and export patterns following the introduction of VAT in January 2006. As a result, the trade deficit widened from 35% of GDP in 2006 to around 37% of GDP in 2007, as imports rose by around 19% year-on-year, outperforming the 15% growth of exports. The positive balances of services, income and current transfers declined as a percentage of GDP from 2006 to 2007, compounding the deterioration of the trade deficit. During the first half of 2008, the current account deficit widened notably by almost 60% compared to the same period a year earlier. This deterioration was due to the expansion in the trade deficit by 24.1% year-on-year, as the value of imported goods rose by 19.6% year-on-year, exceeding the corresponding increase in exports by 5.6pp. A number of branches, such as mining and manufacturing of wood products, base metals and motor vehicles, showed signs of slowing down. Other components of the current account improved in an annual comparison with the first half of 2007: The services balance rose by 19.9% on the back of well performing tourism and transport sectors, while the income balance increased by 24.3%. In conclusion, despite a temporary improvement in 2006 external imbalances widened again in 2007 and 2008.

In 2007, the current account deficit was fully financed from net FDI, as the major privatisations of Telekom Srpska and the RS refineries contributed to a surge in net FDI to 13.3% of GDP, thus replacing, albeit temporarily, the financial sector as the traditional main destination for FDI. Together with other strong financial inflows, such as private sector remittances that accounted for around 17% of GDP, net FDI led to an annual increase of around 23% in official foreign exchange reserves at the end of 2007. In the first six months of 2008, however, net FDI declined strongly compared to the same period in the previous year and covered only 24% of the current account deficit, highlighting its overdependence on privatisations and insufficient green-field investment and revealing potential vulnerabilities in the context of global financial turmoil. As a result, it was mainly financed through portfolio investments, a drawdown of the commercial banks' foreign assets, new external trade credits and a marginal fall in the central bank's official foreign exchange reserves. Total external debt is estimated at around 50% of GDP. So far, the international financial crisis has had only a limited direct impact on the economy although it may have contributed to declining FDI inflows and decreasing external loans. Moreover, the widening current account deficit creates additional external financing needs rendering the economy vulnerable to possible disruptions in capital flows. The risk of a sudden stop or reversal of capital flows seems limited, but higher risk premiums and refinancing costs could put further pressure on the external side.

The results of the Labour Force Survey (ILO standards) of May 2008 show the unemployment rate in BiH falling to 23.4% of the labour force, from 29% a year earlier. Labour force participation remains very low, at about 44% of the total working age population and informal employment is still high. Informal economic activities are fuelled by a poor regulatory framework, inappropriate tax and expenditure policies and weaknesses in law enforcement. Labour market indicators continue to be somewhat more favourable in the RS, where the activity rate remained around 47% against 42.4% in the Federation, while the unemployment rate declined to 20.5% and to 25% in the Federation. Starting in the second half of 2007 and continuing in 2008, registered labour data show employment growing faster in the Federation. However, the increase in registered unemployment in 2007, largely as a result of the Law on Demobilised Soldiers and Their Families, prevented the unemployment rate falling even more. Slow expansion of productive capacities and structural rigidities - high rates of social contributions, distorted wage-setting mechanisms, high and poorly targeted social transfers and low labour mobility - hamper job creation and labour market participation. On the other hand, the setup of a pension reserve fund and the drafting of the law on voluntary pension funds sets off the reform of the pension system towards individualised savings plans in the RS. Overall, unemployment remains very high, although improvements can be noted.

The monetary policy of the Central Bank of Bosnia and Herzegovina (CBBH) continued to be conducted under a currency board arrangement, with the euro as the anchor currency. As of January 2008, the CBBH increased the reserve requirements rate from 15% to 18%, with a view to slowing down credit growth, which had accelerated from an annual 23.4% at the end of 2006 to 28.5% at the end of 2007. The measure was successful in the sense that the credit growth rate did not continue this upward trend but stabilised at around 29% during the first half of 2008, though the trend could also not be reversed. Credit growth was also influenced by the relaxation of the banking prudential regulations on liquidity risk management, rising input prices translating into a higher demand for working capital loans and greater overall credit availability through the operation of the RS Investment-Development Bank. The annual growth of broad money slowed from around 25% at the end of 2006 to 14% at the end of June 2008. Its coverage by foreign exchange reserves declined marginally, but remained sufficient at around 84% at the end of June 2008. Inflation started to pick up in the second half of 2007, driven by an increase in the prices of food, energy and transport and reached an annual rate of 4.9% in December. It further accelerated to 9.9% in July 2008, before coming down to 9.5% in August. The annual average inflation of the first eight months of 2008 stood at 8.0% in BiH, after 1.5% in 2007. In conclusion, the currency board arrangement continued to function smoothly, despite a relative acceleration in the growth of domestic lending.

The large increase in public spending that was initiated in 2006 in the context of the fiscal space created by the introduction of VAT continued in 2007 and 2008. From 2005 to 2007, public spending in BiH increased by 4.5% of GDP from an already high level. In 2007, the good performance of budget revenues growing by around 15% from 2006 could not prevent a deterioration of the fiscal position. Moreover, collection of indirect revenues is projected to decelerate in 2008, following trade liberalisation under the Stabilisation and Association Agreement (SAA) and increasing VAT refunds, even though for the first half of 2008 an annual increase of 8% can be registered. As a result, the surplus of close to 3% of GDP recorded in 2006 which declined to 1.3% of GDP in 2007 may turn into a deficit in 2008. In 2007, public spending grew strongly in both entities and less so at the State level. In the Federation, the quality of public spending worsened, as the increase in expenditures was mostly accounted for by higher government consumption and higher social transfers fuelling private spending. Following the adoption of the laws on demobilised soldiers and civilians with disabilities, social transfers surged at an annual rate of close to 30% in 2007. Expenditures rose further in 2008 and led to liquidity problems in May. In 2008, total public spending in the Federation is projected to increase by another 3% of GDP. At the same time, there was an acceleration of public investment in both entities, which is necessary in order to make up for the declining number of donor-financed projects. However, only in the RS did it account for a large part of the overall increase in spending, reaching almost 6% of GDP last year. The public sector wage bill rose sharply in 2007, by around 19% in the RS and 15% in the Federation. In the RS, there was a further acceleration in the growth of public sector salaries in 2008, as they are gradually catching up with those at State and Federation levels. In general, slippage in public sector wages and social transfers is undermining the competitiveness of the private sector and fiscal sustainability.

The reform of direct taxation continued its progress as the Federation followed up on the changes initiated last year by the RS and reduced the corporate income tax rate from 30% to 10%, aligning it with the rates in the RS and Brčko District. The law also avoids double taxation within BiH. In addition, the Federation simplified the personal income tax system by introducing a 10% income tax rate on overall income as of 1 January 2009. The Federation enacted changes to the social security legislation, but the reduction of the overall rate of social contributions does not address sufficiently the issue of the high labour tax wedge. The adoption of the law on salaries in the BiH institutions and the reform of public wages in the RS simplified the wage structure and consolidated some allowances with wages. At the same time, the reforms are expected to increase the wage bills further in 2008 (this is already being seen in the RS) and also to establish a wage indexation mechanism at State level, with negative fiscal spill-over effects beyond 2008. The establishment of the National Fiscal Council should contribute to better fiscal coordination and discipline in the country. In conclusion, there has been continued fiscal slippage in 2007 and 2008, accompanied by a deterioration in the quality of public spending in the Federation.

The external public debt of Bosnia and Herzegovina continued to decline, from around 21% of GDP at the end of 2006 to 18% at the end of 2007, and it further decreased by 2.1% during the first half of 2008. Domestic public debt, on the other hand, accumulated further as both entities are implementing the legislation on the settlement of liabilities from frozen foreign currency deposits and from war damages. It is estimated at around 12% of the entity's 2007 GDP in the Federation and 24% in the RS. Total public debt is estimated to have increased from 22% of GDP in 2006 to 30.5% of GDP in 2007. In addition, the bill on restitution, which has not yet been adopted, may jeopardise fiscal sustainability if it fails to align financial compensation with the budget’s long-term ability to pay. Finally, the issue of quasi-fiscal deficits stemming from the accumulation of budget arrears and other liabilities by state-owned enterprises (SOEs) in respect of employees and suppliers remains largely unaddressed in the Federation, which further adds to the fiscal risks. Debt management improved as the Federation adopted a new Debt Law which limits government borrowing, similar to the laws passed in the RS and at State level. In conclusion, progress has been made in settling domestic claims, which will gradually increase the current level of indebtedness.

The macroeconomic policy mix worsened in 2007 and in the first half of 2008. Fiscal risks are mounting, in particular in the Federation, where large commitments on social spending were made in a context of decelerating budget revenues. In addition, the public sector wage policy has been relaxed at all government levels through wage increases and wage indexation mechanisms that weaken fiscal sustainability and external competitiveness. The monetary policy was aimed at tightening credit conditions, but was not fully coordinated with decisions in the area of banking prudential regulations. Overall, the macroeconomic policy mix worsened as the fiscal policy became strongly expansionary, fuelling inflationary pressures and the widening of the current account deficit.

Interplay of market forces

After the large privatisations in 2007, RS continued to make progress in privatisation, and so far around 68% of the initial stock of state-owned capital slated for privatisation has been sold and about 15% of the same stock was transferred into public funds for pension insurance and restitution. Apart from the successful sale of strategic enterprises, the process was slowed somewhat by changes in the legal framework, which transferred privatisation sales and management competences to the RS Investment-Development Bank. In 2007, around 18 companies were privatised, while in the period from January to September 2008, 13 additional companies were sold. In July, the new Law on Takeover of Shareholding Companies in the RS entered into force. The privatisation process almost came to a halt in the Federation in 2007 and the first half of 2008, mainly due to the conflicting interests involved, a complex decision-making structure and sizable social and financial obligations accrued by the SOEs. Between October 2007 and June 2008, the Federation sold stakes in only five companies and the privatised capital remained at around 41% of the initial stock slated for privatisation. The cancelled tenders for some strategic companies (e.g. Energoinvest and Hidrogradnja) were not reissued and the sale of Aluminij d.d. Mostar remains in limbo due to negotiations over the subsidised power price. The Federation government submitted a new privatisation strategy to the Parliament, which – if approved – should unblock the privatisation process, also by defining options for the sale of the telecom operators. Neither entity yet has any concrete plans regarding the privatisation of the utilities sector. The share of the private sector as a percentage of GDP rose to approximately 60% in 2007. In conclusion, progress in privatisation continued to be uneven across the country.

Market entry and exit

The implementation of a single business registration system has largely been completed and the number of days and the procedural requirements to register a business have been reduced. Courts in the BiH, the fiscal administration offices and the statistics agencies have been networked. The regulatory impact analysis aimed at reducing red tape, known as the "guillotine process", was completed in the RS, while the Federation started it. Bankruptcy procedures have improved and the number of cases initiated and closed by the courts has gradually increased. The RS has amended the Law on Bankruptcy Procedure, which includes limiting the bankruptcy procedure to a maximum of one year. Over one hundred non-viable SOEs are in bankruptcy procedures in the RS. It is also now quicker and easier to obtain construction permits and to register property. At the same time, only limited progress was made in improving the procedures for obtaining licences, enforcing contracts, employing workers or paying taxes – all of which make doing business rather difficult. Overall, company and property registration, and dealing with construction licences and bankruptcy procedures have improved, but market exit remains ineffective, in particular for insolvent SOEs. Further efforts are needed to improve the business environment.

The legal system

The functioning of the judicial system improved slowly and the courts processed a higher number of cases than those submitted in 2007. Even so, a total backlog of about 1.9 million cases was recorded at the end of 2007 (including approximately 1.2 million cases of unpaid utility bills). A Backlog Reduction Project has been launched and concrete results are expected in particular with regard to utility bills and minor offence cases. A Case Management System has been gradually introduced into courts, leading to an improvement in the management of cases. The authorities have not yet established commercial courts. Closing a business and enforcing contracts has become somewhat easier as a result of improvements in bankruptcy legislation. Widespread corruption, and also criminal activities, affect the business climate and have a negative impact on the quality of public services. Overall, the judicial system has slowly improved; however, the existing backlog of unsolved cases and the slow processing times are hampering the enforcement of creditor and property rights.

Development of the financial sector

Banks continue to dominate the financial sector and their assets surged to around 93% of GDP in 2007, up from around 77% in 2006, triggered by the acceleration in the growth of domestic credit and a significant increase in short-term foreign assets on the basis of the funds received from the privatisation of RS Telecom. There were 31 banks operating at the end of 2007 (compared to 55 in 2000), with foreign capital controlling about 83% of the total bank capital. Only three banks remain in public hands, and all three are under provisional administration. The five largest banks held around 57% of the total assets of the banking system at the end of 2007, slightly less than in 2006. Together with the narrowing of interest spreads, this shows that bank consolidation is not obstructing competition in the market.

The non-bank financial sector is expanding rapidly. Four new leasing companies began operating last year, bringing the total number of companies to ten. Leasing contracts worth approximately € 380 million (3.6% of GDP) were concluded in 2007; this figure was 62% higher than in 2006. At the end of 2007, there were 12 microcredit organisations active in the Federation and six in the RS. The sector originated some € 500 million in new loans (4.6% of GDP) - a 61% increase over 2006. In the insurance sector, 25 active companies collected around € 200 million in insurance premiums (1.9% of GDP) in 2007, which was 12% more than in 2006. The adoption of new bylaws on financial reporting and solvency margins in 2007 is expected to enable the uniform functioning of the insurance sector in the country. The stock markets have undergone a major correction since the second half of 2007 and the main indices have lost around 60% of their value since October 2007. Nonetheless, total turnover at both the Sarajevo and Banja Luka Stock Exchanges in 2007 increased by more than 90% over 2006. Their combined market capitalisation increased to 111% of GDP in 2007 from 99% of GDP in 2006, but declined in 2008. The bond market started to develop through the issuance of government securities, municipal and corporate bonds. In conclusion, the financial sector develops rapidly.

Financial stability indicators continued to strengthen in 2007, as they too were influenced favourably in the short-term by the high rate of credit expansion. Non-performing loans as a percentage of total loans fell to 1.8% in 2007 from 2.5% in 2006. The capital adequacy ratio was 17.1% at the end of 2007, i.e. marginally higher than the previous year and well above the legal minimum of 12%. At the end of 2007, the average return on equity increased further to 8.9%, indicating an improvement in profitability. However, profitability indicators strongly deteriorated in the first quarter of 2008 compared to the first quarter 2007. The liquidity situation of banks also tightened, even though it could still be considered as good with the financial sector being able to meet its obligations. The authorities strengthened certain areas of financial supervision with a view to increasing the stability of the financial system. Overall, despite the volatility in international financial markets and the rapid expansion of the financial sector, financial stability has largely been maintained and the financial sector so far remained relatively immune from first-wave effects of the global financial crisis.

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

Existence of a functioning market economy

Macroeconomic stability has weakened and economic operators need to be able to deal with increased risks stemming from expansionary fiscal policies, higher inflation and widening external imbalances. Structural reforms advanced in some areas and the consensus on economic reforms and coordination of policies strengthened. However, the continuing excessive influence of the public sector in the economy, in particular slow privatisation and restructuring or liquidation of insolvent SOEs in the Federation, is hampering the efficient allocation of resources by market mechanisms.

Human and physical capital

Enrolment rates for secondary and higher education, including graduation rates, remain fairly low. The Law on Vocational Education Training has been adopted, but implementation of the Higher Education Law has been slow. Coordination between the 14 ministries of education has improved somewhat. In general, the education reform has been lagging behind. Participation in the labour market remains very poor. Active labour market programmes are being implemented, some of which focus on training and improving the skills of job-seekers. However, only limited progress has been made in removing structural rigidities and building up the productive capacity. Overall, the weak performance of the education system contributes to the skills mismatch that hampers the proper functioning of the labour market.

Investment increased to around 26% of GDP in 2007, of which about half was allocated to machinery and equipment and some 45% to construction works in the Federation. The increase of FDI inflows into Bosnia and Herzegovina in 2007 brought the total stock of FDI per capita to around € 1,150. Upgrading of the telecommunications and transport infrastructure, and particularly of local roads, has continued. The penetration of landline telephones, mobile connections and internet usage has increased further. However, the growth of the local IT market of 13.4% in 2007 was moderate considering the very low base. Contracts have been signed for several large investments in energy and infrastructure. In 2007, there was a strong acceleration in public investments, primarily in the RS, where they more than doubled in nominal terms compared to the previous year. In conclusion, the upgrading of physical capital continued at a faster pace, based on FDI inflows and higher public spending.

Sectoral and enterprise structure

The restructuring and liquidation of SOEs has made very slow progress. This process has been hampered by the SOE's accumulated unsettled arrears against the budget, employees, utilities and suppliers and by the vested interests of enterprise managers, trade unions and decision-makers. In the RS, more than a hundred SOEs are in liquidation, and the RS Investment-Development Bank has been carrying out financial restructuring programmes for those enterprises being privatised. The Federation has similar enabling legislation in place, but instead has come forward with plans to financially consolidate the loss-making mines and provide them with debt relief from the budget and from the electricity companies with whom they are subsequently to be merged. This has significant fiscal implications and may actually hold back the process of enterprise restructuring. Liberalisation of network industries has continued at a slow pace. As of 1 January 2008, the electricity market was liberalised for all buyers, except for households. Furthermore, the unbundling in the energy sector has been further complicated by the Federation's plan to merge the mines with the electricity companies. Little progress has been made as regards the gas sector. Current plans to privatise the two telecom companies in the Federation may facilitate the further liberalisation of the telecommunications sector. To conclude, progress in the restructuring and liquidation of SOEs has been slow and uneven across the country. Liberalisation of network industries continued at a slow pace.

There was a further shift in the sectoral structure of the economy towards services, i.e. retail and wholesale trade, financial intermediation and real estate. At the same time, the contribution of public administration, education and health to gross value added in the economy remains fairly large, given that they have not displayed enough of an improvement. Exports and industrial production reveal a gradual but slow shift towards higher value-added goods. The small and medium-sized enterprises (SME) sector is growing, and enjoys increased access to financing from private, public or EU funds. Lending by microcredit and leasing companies grew by around 60% in 2007. In addition, in the RS some of the proceeds of privatisation are being channelled to SMEs through the RS Investment-Development Bank, with the Federation following suit by establishing its own development bank through the transformation of the previous Investment Bank. Improvements in the business environment are primarily benefitting the SME sector, mainly in the shape of improved access to finance. The informal sector remains large. Overall, structural shifts in the economy are slow and SMEs continue to operate in a complex business environment.

State influence on competitiveness

After an initial State aid inventory for 2004-2006 was carried out in 2007, no further progress on improving the transparency of state-aid was made. The inventory showed that State aid was increasing. In 2007, budget subsidies increased slightly as a share of GDP and are largely allocated to loss-making SOEs in an ad-hoc and non-transparent manner. In addition, quasi-fiscal deficits continue to accumulate through the build-up of arrears to the budget, state-owned utilities or employees. Overall, State intervention in the economy is still too high.

Economic integration with the EU

Bosnia and Herzegovina is an open economy with total trade equivalent to around 95% of GDP in 2007, up from about 87% of GDP in 2006. The real effective exchange rate declined by 1.7pp from June 2007 to June 2008. The EU continues to be the most important trading partner with shares of around 57% of Bosnia and Herzegovina's total exports and of 48% of its total imports in 2007, although its weight is slightly declining. This decline should be seen in the context of the price increases for energy, commodities and food and of deeper regional trade integration through CEFTA. At the same time, the signing of the SAA and the entry into force of the Interim Agreement are likely to deepen this relationship and expand trade integration with the EU. The share of FDI inflows from the EU declined temporarily in 2007, after the major privatisations in the RS with non-EU buyers. Overall, the level of integration of trade and investment with the EU remained fairly high.

5.4. CONCLUSIONS

The **economy** of Bosnia and Herzegovina has continued to expand rapidly. Macroeconomic stability weakened as a result of widening external deficits, higher inflation, and expansionary fiscal policies. The persistence of very high unemployment and low labour market participation in the country remains a major cause of concern together with diverging reform paths between the entities.

As regards the **economic criteria**, Bosnia and Herzegovina has made some uneven progress towards becoming a functioning market economy. Further considerable reform efforts must be pursued with determination to enable the country to cope over the long term with competitive pressure and market forces within the Union.

Some progress was made in reaching consensus on the fundamentals of economic policy, and inter-entity cooperation in economic policy areas has improved. A commitment to improve fiscal coordination was made through the adoption of the law on the National Fiscal Council and the inauguration of the Fiscal Council under the new law in early September. Agreement was reached on the allocation of indirect taxes. The currency board arrangement continued to function smoothly and financial stability was maintained for the most part despite international volatility and the high growth rates of domestic lending. Some labour market indicators improved. High corporate and income tax rates in the Federation were reduced and legislative measures were taken to avoid double taxation in the country.

The business environment improved somewhat in the areas of business registration, bankruptcy procedures and land registration. The SME sector is benefiting from better access to financing. FDI surged in 2007, driven by the large privatisations in Republika Srpska and fully covered the current account deficit. The upgrading of physical capital accelerated, also supported by rapidly growing public investment in Republika Srpska.

The fiscal slippage, which began in 2006, continued in 2007 and 2008. In the Federation, fiscal risks have risen owing to large commitments on social spending made against decelerating budget revenues. In addition, the public sector wage policy has been loosened at all government levels through wage increases and indexation mechanisms that weaken fiscal sustainability and private sector competitiveness. Restructuring and liquidation of state-owned enterprises advanced slowly, with only marginal progress being made in privatisation in the Federation. Unemployment has remained very high.

The shift in the structure of production towards higher value-added activities remains sluggish. The weak productive capacity and structural rigidities - high rates of social contributions, distorted wage-setting mechanisms, high and poorly targeted social transfers and low labour mobility – hamper job creation. The business environment is still affected by administrative inefficiencies. The large informal sector is fuelled by a weak regulatory framework, by inappropriate tax and expenditure policies, and by weaknesses in law enforcement, including the fight against corruption and organised crime. This remains an important challenge, as it reduces the tax base and the efficiency of economic policies.

6. MONTENEGRO

6.1. INTRODUCTION

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

6.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Montenegro submitted its second Economic and Fiscal Programme (EFP), covering the period 2008-2010, by the end of November 2007. The fiscal strategy of the government aims at capitalising the strong economic growth in order to finance measures to strengthen administrative capacity, invest in infrastructure and reduce the public debt. The political consensus on the economic reform agenda was challenged on a few occasions: at the time of adopting the Laws on ownership relations and State property, the new Law on banks and the amendments to the Concession Law. Overall, the coalition government retained political consensus on market-based economic policies.

Macroeconomic stability

Economic growth remained strong in 2007, expanding well above 8% in real terms, boosted by strong inflows of FDI and robust domestic demand. The solid performance of the economy continued during the first half of 2008, with GDP growing by 8% year-on-year. Services, notably tourism, financial intermediation and real estate, remained the main driver of growth, generating some 70% of gross value added (GVA). Around 20% of total growth was attributable to industrial output and construction. On the demand side, consumption remained solid as cumulative retail sales grew by 18% in real terms in the first eight months of 2008, supported by increasing household incomes. As a consequence of the robust economic growth, Montenegro's per capita income, measured in purchasing power standards (PPS), increased in 2007 to around 32% of the EU27 average. Overall, economic growth remained strong boosted by FDI and domestic demand.

Exports of goods hardly improved in 2007, increasing by some 2% reflecting the weak competitiveness of local products but also the volatile international price of aluminium, which accounts for almost half of total exports. FDI inflows surged by 56% in 2007 and combined with a robust domestic demand induced a widening of the trade deficit to 55% of GDP. The already sizeable current account deficit further expanded from 24.7% of GDP in 2006 to about 34% in 2007 despite the strong increase in the balance of services surplus. Meanwhile concurrent huge outflows, mostly due to real estate sales by foreigners, brought net FDI down to 22% of GDP. The coverage of the current account gap by FDI flows decreased to 52% (compared with 88% in 2006). The deficit is increasingly being covered by repatriation of domestic banks' net foreign assets and external private borrowing. Stronger than expected fiscal performance allowed early repayment of foreign loans bringing the public external debt down to 20.3% of GDP at the end of 2007. External imbalances continued widening during the first half of 2008 as the trade deficit deteriorated. The stagnation on the domestic capital market resulted in a significant outflow of portfolio investments. The public external debt continued to decrease, ending on 17.5% of GDP at the end of June 2008. Overall, the current account deficit widened, driven by a strong inflow of imports while its coverage by net FDI declined, increasing vulnerability to external shocks.

The fast-growing economy required labour resources beyond the country's capacity. Market rigidities and lack of mobility resulted in a shortage of seasonal workers, notably in tourism, construction and agriculture. Shortages are being covered by foreign labour, mostly from Serbia. According to the labour force survey (ILO standard), in the first quarter of 2008, the participation rate was 59.7% and the unemployment rate 18%. Employment growth remained steady during the first half of 2008, recording 6% average expansion year-on-year. However, partly due to the significant size of the informal economy, changes in registered unemployment may not correctly reflect the actual dynamics of the labour market. Overall, the unemployment rate decreased and together with the mismatch of labour skills exerted upward pressure on wages in both the public and private sectors.

Montenegro unilaterally uses the euro as legal tender, without participating in the euro area. Consequently, its monetary policy is limited to operation of liquidity management. So far, the international financial crisis has had only a limited direct impact on the financial sector. Yet, the rising current account deficit, increasingly financed by repatriation of domestic banks assets abroad, has become a matter of concern, particularly under current capital markets conditions. Also, higher risk premiums and refinancing costs have already started putting pressure on the external side. The Montenegrin authorities have taken a series of measures, including higher capital adequacy requirements for domestic banks, an unlimited coverage for deposits insurance as well as a guarantee scheme for intra-banking lending.

The rapid growth of bank deposits expanded the money supply from 74% of GDP in 2006 to 112% in 2007, as the stock of domestic credit soared to 98% of GDP. However, restrictive measures introduced by the Central Bank (credit growth ceilings and higher minimum solvency coefficients) succeeded in moderating the elevated credit activity of domestic banks in 2008. The annual rate of lending decelerated to 25.8% during the first eight months of 2008, compared with 93% in December the previous year. Average annual inflation accelerated from 3% in 2006 to 4.3% in 2007, notably due to a significant increase in food and energy prices. Consumer prices peaked at 11.4% up year-on-year in June 2008, slowing down to 9.5% in August on easing food and transport prices. Overall, lending activity decelerated in 2008, while inflation increased sharply.

The 2007 budget showed a very strong growth in tax revenue, resulting in a record surplus above 7% of GDP. Proceeds from VAT and from personal and corporate income taxes rose strongly above target, reflecting the effectiveness of previous reforms of direct taxes and the tax-rich growth pattern. Total public spending grew to 47% of GDP. Expenditure on gross wages expanded considerably to 14.5%, while transfers to State funds and local self-governments increased more moderately. The government decided to allocate the budget surplus achieved up to mid-October to reducing foreign public debt by 8.3%, raising wages of civil servants by 30%, and increasing capital expenditures to 7% of GDP. Nevertheless, at the end of the year the budget was still showing a strong surplus.

The positive fiscal performance continued during the first half of 2008, when a surplus of 2.9% of annual GDP was recorded. Rapid growth was observed in both revenue and expenditure. Tax revenue expanded by 28.4% year-on-year as a result of rising collection and strong proceeds. The other main developments in the 2008 budget were the 22% year-on-year increase in gross wages and the expansion of transfers to public institutions. In contrast with previous financial years, capital expenditure in 2008 was executed as planned. In July 2008 the parliament supported the amended budget, proposing targets 11.4% higher for both revenue and expenditure, while the planned surplus remained unchanged. Overall, buoyant revenues were the main driver behind the improved balances.

The public debt continued to decrease to 30.4% of GDP in 2007 as the good fiscal outcome enabled several early repayments to international financial institutions. However, it expanded to 33.6% of GDP in the first half of 2008, as the share of domestic debt in the total rose. In particular the government recognised additional obligations from ongoing restitution procedures, old foreign currency savings deposited in two Serbian banks, and unrecorded liabilities of the State funds to commercial banks. Overall, the public debt rose following recognition of domestic liabilities from the past.

Macroeconomic policies aiming at reducing the public debt have been an appropriate mean to contain potential external vulnerabilities, but not sufficient given the country's use of the euro and the limited scope for monetary policy instruments. The debt-management policy was complemented by a reshaping of fiscal revenue, reducing the burden of direct taxation in order to stimulate growth. However, the Central Bank needed to implement a restrictive monetary policy to bring the surge in loans extended by commercial banks (165% annual expansion in 2007) back to more sustainable levels in 2008.

Interplay of market forces

Electricity prices were further liberalised and the cross-subsidisation between the enterprise and household consumers was reduced. The government took measures to alleviate the increase in food prices. In September 2007 it introduced a package of temporary measures to stimulate agricultural production by reducing VAT rates, supplying farmers with raw materials or increasing guaranteed prices to producers.

The privatisation process accelerated after the adoption of the new constitution. More than 85% of the State-owned capital has been privatised already. Key sectors such as banking, telecommunications and the metal industry have been fully privatised. Out of 59 companies slated for privatisation in 2008, fewer than half display State ownership above 50%. A significant number have already been put up for sale over the reporting period. However, a few of them failed to attract investors, while in other cases the sales contracts were not concluded. Since the end of 2007, the government has announced a new type of tenders for developing a series of seaside locations, mostly former military properties, into high-end tourist resorts under lease conditions. Overall, the privatisation process has further advanced, although the sale of a few companies failed for lack of investor interest.

Market entry and exit

In 2007 the number of companies registered with the Commercial Court increased significantly. However, because the procedure to register new companies is inexpensive, a number of these remain inactive after a single operation. While business registration is quite simple and takes four days at most, starting actual operations may require significantly more time to obtain the compulsory licences. There is also a disparity in requirements and the costs for obtaining the same business licences depending on each municipality. So far, most improvements have come from initiatives by central government or agencies, such as adoption of the draft law on domestic trade, which replaced the need to obtain municipal business licences by a declaration by the entrepreneur of intent to launch trading activities. Overall, market entry procedures are improving, but one-stop shops, though considered, have not yet been introduced.

In 2007 the Commercial Court registered 371 new bankruptcy procedures, and closed 359. The average length depends on the legal basis applicable. Under the 2006 Law on insolvency of business organisations, the most complex cases may take a maximum of one year, compared with up to 10 years under the previous law. Overall, market exit delays have been reduced considerably by the implementation of new legislation.

Legal system

The main obstacles to an effective business environment remain the weak rule of law and the costs and delays for obtaining business licences and for property registration. Yet, corruption and criminal activities may hinder the development of the formal sector and affect the business environment. The regulatory framework further improved with the establishment of two new institutions: a mediation centre to facilitate simple resolution of commercial disputes, and a council for elimination of business barriers. Overall, progress has been achieved in several areas influencing the business climate, but further efforts to establish a transparent system are needed.

Financial sector development

The size of the banking sector in terms of assets grew to 131% of GDP by the end of 2007, making it one of the major driving forces of the Montenegrin economy. The sector remained concentrated, with three banks holding 37% of the total capital, 64% of the banking sector's assets and 73% of the total deposits. However, competition in the banking sector reduced lending rates. The average weighted effective interest rate stood at 9.1% at the end of 2007, while the real interest rate remained much lower, at 1.4%. In 2007, the Central Bank adopted a package of measures to increase the security of loans, and dampen credit expansion. In January 2008 centralised registration of credit operations was introduced, allowing commercial banks to improve their risks management. In February 2008 parliament adopted a new Law on banks, providing for more detailed regulation of the sector with improved supervision of the banking system. The Law aims to bring the banking legislation closer to international standards, especially the EC Capital Requirements Directives . The banking prudential indicators remained sound in 2007, although positively influenced by the strong growth of lending. The share of non-performing loans decreased to 3.2% of total loans. The capital adequacy ratio declined to 17.1%, well above the minimum 12% required. Average bank profitability declined marginally. Overall, despite the intensive lending activity, the stability of the banking sector has been maintained.

The insurance industry accounts for some 2% of GDP and is primarily made up of compulsory insurance (i.e. for motor vehicles) which accounts for half of total premiums, whereas life insurance covers just 4.5%. The sector remains highly concentrated, with one company holding a 66% market share. The leasing sector continued to expand strongly in 2007, increasing from 3.7% of GDP in June 2007 to 5% at the end of the year. The capital market comprises two stock markets. In early 2008 one of the stock exchanges launched a takeover bid, but failed to take control of its rival. Eight investment funds and some 32 brokerage companies participate in the market. A number of banks also participate in the capital market by founding pension funds, forming broker associations or performing custody operations. Overall, the non-bank financial sector grew rapidly, especially driven by leasing, while the stock markets remained volatile.

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

Existence of a functioning market economy

Macroeconomic stability has weakened as external exposure increased in 2007 and the first half of 2008 owing to strong demand pressures revealed by rising inflation, widening external imbalances and a moderately pro-cyclical fiscal stance. Nevertheless, continuation of the already advanced privatisation process and implementation of the other structural reforms to which the government is committed are facilitating more efficient allocation of resources by market mechanisms. However, despite significant progress in improving the business environment, weaknesses and sometimes insufficient resources on the part of supervisory and regulatory agencies are still impeding the consolidation of a more level playing field for market participants, thus providing leeway for informal practices.

Human and physical capital endowment

Enrolment in primary and secondary schools remains high. The number of university students rose to 3.1% of the total population, approaching the EU-27 average of 3.8%. Vocational training was reinforced thanks to cooperation with international institutions. The employment agency and the Directorate for Small and Medium-sized Enterprises (SMEDA) continued to implement active measures promoting self-employment and vocational training along with a strategy for life-long entrepreneurial learning, with special emphasis on the less developed northern region. A new labour law was adopted in July 2008. In September, the government adopted the mid-term programme for promotion of employment and development of the human resources for the period up to 2011, with the aim of creating favourable conditions for building a competitive and dynamic knowledge-based economy. The up-grading of human capital continued, although retraining programmes offered by the employers are not yet sufficiently developed.

Capital formation increased substantially owing to very strong net FDI, bank financing to corporations and government capital spending. The restructuring of the electricity industry, railways, airports and the port of Bar are underway. The telecommunications sector saw further development by providing alternatives to fixed telephony and offering significantly cheaper international calls. Mobile telephony continued to expand, recording a penetration rate above 200% in July 2008. Overall, investments increased both in volume and quality of sector allocation as real estate investments declined relative to other production activities.

Sector and enterprise structure

Large and enduring trade deficits reflect the narrow production base, limited competitiveness of local products and strong inflows of foreign capital. The labour structure shows a significant share of workers in government administrations or in public companies. This situation decreases the external competitiveness of the more productive tradable sector. Overall, with about 70% of its narrow economy employed in services, Montenegro relies on upgrading the quality of its offer into the upper end of the market to improve both competitiveness and productivity.

The privatisation strategies for the transport and energy sectors were adopted in 2007 and their implementation engaged. It was decided to restructure the national railways into two joint stock companies: one for transport, the other for infrastructure. In 2008 the incumbent power utility EPCG launched unbundling of the company into five separate business units to be integrated vertically into a single energy holding. Meanwhile, the Privatisation Council launched recapitalisation of the company, seeking a strategic investor to provide funds for its development, while the government retains a 55% share. Given the complexity of the restructuring, the opening of the electricity market to qualified consumers has been delayed until the end of 2008. Meanwhile, the recently established Energy Regulatory Agency has adopted a series of decisions to enhance the legislative framework and further develop the sector.

The restructuring of the industrial port of Bar was launched with the adoption of the Law on ports in July 2008. The State retains ownership of the infrastructure via the port authority, while business activities will be privatised as a separate port operating company. The first phase started with the selling of non-core business activities to provide for the severance indemnities of redundant workers. As regards the national air carrier, the shareholders assembly in July 2008 decided to proceed with privatisation by recapitalising and selling 30% of the company on the capital market. Overall, restructuring of the transport and energy sectors advanced further, although it remains one of the main challenges.

The sectoral structure of the economy continued to shift towards services, which generated the largest share of employment (67%); with tourism, financial intermediation and trading expanding faster.

Industry accounted for 26%. Nevertheless, the public sector, including both industry and services, accounts for a significant share of total employment and is also the sector where employment expanded fastest. The share of agricultural workers continued to decline and fell to 7%. Still, the informal sector remains large in most areas of the economy. Overall, industry is giving way to more profitable sectors like tourism and construction, ensuring a more diversified growth path.

SMEs are mostly geared to the domestic market and only around 15% of them export outside the former Yugoslav territory. Companies have benefited from the surging credit activity of banks, with two thirds of credits being allocated to them. However, SMEs continue to find it more difficult to obtain loans, given the lack of sound financial statements or collateral, and are therefore resorting increasingly to leasing to acquire facilities, vehicles and equipment. In June 2008, the Central Bank adopted a decision on credit guarantee services, providing the legal basis for establishment of credit guarantee funds to support SMEs access to financing. Overall, the expansion of the SME sector continued, albeit at a slow pace, as the recently adopted government's operational plan for eliminating barriers to entrepreneurship is at an early stage of implementation.

State influence on competitiveness

Early in 2008 the Ministry of Finance adopted decrees on conditions for granting state support. State aid is primarily granted to companies undergoing restructuring or privatisation and takes the form of debt relief or severance payments to make their sale more attractive to potential investors. In the case of the metal smelters, electricity subsidies running until 2011 were also included in the privatisation deals. SMEs may benefit from aid to participate in international fairs, to promote competitiveness or to improve managerial skills. But public support cannot be granted to SMEs dealing with shipbuilding, agriculture and fisheries. Overall, the amount allocated in the government budget for direct subsidies remains very small.

Economic integration with the EU

The trade component of the Stabilisation and Association Agreement entered into force by virtue of an Interim Agreement on 1 January 2008. Montenegro remains a very open economy, with total trade in goods and services above 150% of GDP. In 2007 the services sector became the major source of export revenue due to the performance of the tourism industry, which recorded higher revenue than the traditional metals trade. The main destination for domestic producers goods remains the EU, which took 65% of total exports in June 2008, followed by the CEFTA countries (33%). In the case of imports, 50% of Montenegro's imports come from CEFTA partners and 41% from EU countries. FDI from the EU totalled EUR 534 million or 53% of total inflows, followed by 18% from Russia and 7% from Switzerland. Although the share of European investment decreased slightly compared with 2006, it expanded in nominal terms by 45% year-on-year. Overall, economic integration with the EU remains high.

6.4. CONCLUSIONS

The **economy** of Montenegro has continued to expand vigorously. The pace of structural reforms accelerated and institutional capacities were reinforced. Macroeconomic stability weakened due to rising inflation and external vulnerabilities. Shortcomings in the rule of law and their resolution remain the key challenge for economic development.

As regards **economic criteria**, the country has made further progress towards establishing a functioning market economy. Completion and swift implementation of the ongoing reforms is required to cope in the medium term with competitive pressure and market forces within the Union.

Economic growth remained robust, driven by strong inflows of FDI and domestic demand, further lowering the unemployment rate. The deceleration of lending growth of commercial banks to more sustainable levels in 2008 reinforced macroeconomic stability. The strong fiscal position enabled additional capital investment and a further reduction of the external public debt. The privatisation process accelerated, reducing the exposure of public finances and enhancing competitiveness.

Restructuring of the transport and energy sectors got underway. Regulation and functioning of the financial services sector improved with the revision and implementation of a new banking law, and the setting-up of an insurance supervisory agency. The Council for the elimination of business barriers was established. The upgrading of human resources continued with the implementation of more efficient training programmes. Economic integration with the EU remains high.

However, the current account deficit reached unprecedented levels, and the structure of its financing became less favourable. The fiscal stance remained accommodative despite the temporary nature of the cyclical upswing. Headline inflation increased due to rising energy and food prices. The mismatch and shortages of labour skills drove wages upwards. Privatisation of some companies failed due to lack of investor interest.

Industrial production remained relatively volatile. Export capacity of small and medium-size enterprises is still very limited. Market entry, property registration and delivery of building permits suffer from administrative weakness. The large informal sector is fuelled by a weak regulatory framework and by weaknesses in law enforcement, including the fight against corruption and organised crime. It remains an important challenge as it reduces the tax base and the efficiency of economic policies.

7. SERBIA

7.1. INTRODUCTION

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

7.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In December 2007, the government submitted to the European Commission an Economic and Fiscal Programme (EFP), covering the years 2007-2010. It builds on the budget memorandum of April and the October 2007 update thereof and presents a generally coherent and ambitious macroeconomic and fiscal framework together with an ambitious agenda for structural reforms. The 2009 budget memorandum was adopted in May 2008 and was followed by an update on 2 October 2008. In early October, the government approached the International Monetary Fund (IMF) on starting negotiating a new Stand-by Agreement, in an attempt to establish an external policy anchor. The government has cited the need for greater ownership of, and autonomy for, economic policy planning and implementation. Overall, consensus on the fundamentals of a market economy has been maintained.

Macroeconomic stability

In 2007, GDP growth accelerated to 7.5%, from 5.7% in 2006. Following a strong performance in the first half of 2007, the Serbian economy slowed down somewhat during the second half of the year. Higher private consumption as a consequence of strongly rising real salaries slowed in the course of the year. Furthermore, the severe drought resulted in a significant drop in agricultural production. Industrial output slowed to about 2.5% year-on-year during the second half of the year, partly due to an overhaul of the US Steel plant. During the second quarter of 2008, GDP growth slowed to 6.2% year-on-year, from 8.2% year-on-year during the first quarter. For the whole first half of 2008, GDP growth reached 7.3% year-on-year. Growth of industrial production accelerated to 6.0% year-on-year during the first quarter of 2008 compared with 0.7% during the fourth quarter of 2007, driven by the resumption of production at US Steel. However industrial output slowed to 2.3% year-on-year during the second quarter of 2008. Average per capita income increased to 35% of the EU-27 average in purchasing power standards, from 33% a year earlier. Overall, economic growth continued to be driven by the services sector, in particular wholesale and retail trade, transport and telecommunications, along with financial intermediation.

In 2007, the current account deficit widened to 12.4% of GDP compared with 9.4% a year earlier, driven by a growing deficit in the trade balance and a decline in current transfers. Strong domestic demand fuelled by a significant relaxation of fiscal and wage policies, coupled with a drought-related export ban on some agricultural products and a drop in steel output, contributed to a deterioration in external accounts. On the financing side, capital inflows remained strong, but slowed during 2007 to 21% of GDP, from 30% in 2006. Foreign direct investment fell to 5.1% of GDP from 13.8% a year earlier when the sale of the second mobile telephone operator yielded substantial revenue. By contrast, financing by medium- and long-term foreign borrowing grew to 10% of GDP, from 9% in 2006. During the first half of 2008, the current account deficit widened to close to 20% of GDP and FDI rebounded below 9% of GDP. At the end of 2007, the stock of foreign exchange reserves of the National Bank of Serbia (NBS) stood at EUR 9.6 billion or 8.3 months worth of imports of goods and services. As a result of the growing debt financing of the external deficit, foreign debt rose to about

EUR 18.9 billion at the end of 2007, equivalent to 65% of GDP, compared with 63% a year earlier. Private- and public-sector foreign debt stood at 43% and 22% of GDP respectively. Debt service has increased to 8.5% of GDP and is projected to continue rising significantly in years ahead. Overall, external imbalances have widened, the quality of financing has deteriorated, foreign indebtedness has grown and the degree of macro-vulnerability of the economy has increased.

By October 2008, the international financial crisis has had only a limited direct impact on the Serbian economy and its financial sector. However, a widening current account deficit and a growing level of external debt create important external financing needs requiring significant capital inflows. To that extent, the external imbalances render the Serbian economy vulnerable to possible disruptions in capital flows. The risks of a sudden stop or reversal of capital flows have recently grown and/ higher risk premiums and refinancing costs could put further pressure on the external side. In particular, a decline in cross-border lending, which has become an important financing source for the domestic corporate sector, could be affected. . The Serbian authorities have recently increased the amount of guaranteed deposits, lifted reserve requirement for banks' foreign borrowings and eliminated the tax on savings income. In 2007, labour market conditions improved slightly. The employment rate rose to 51.5% of the working-age population in October 2007, while the unemployment rate fell to 18.8% compared with 21.6% a year earlier. However, the transfer of about 90,000 unemployed persons from the employment register to the health insurance register, following an amendment to the legislation, contributed to this apparent improvement in the labour market statistics. Nominal wages grew by 22.1% year-on-year on average in 2007, compared with 24.4% a year earlier. Due to a decline in inflation during the first half of 2007, real wage growth accelerated to about 20% year-on-year - substantially stronger than in 2006. However, a renewed rise in inflation starting in the second half of 2007 resulted in a slowing of real wage growth. This trend continued in 2008. During the first half of 2008, nominal wage growth slowed to 19% year-on-years and, due to a higher inflation rate, real wages slowed to 7.8% year-on-year. Overall, despite high economic growth rates in recent years unemployment is still a major challenge.

The new monetary policy framework, introduced in September 2006, aims at a gradual transition towards inflation targeting with explicit targets for annual core inflation rates. Core inflation declined slightly to 5.5% year-on-year in December 2007, compared with 5.9% a year earlier. For the whole of 2007 core inflation remained within the 4-8% target range, despite re-emerging inflationary pressures stemming from rising aggregate demand, the drought-related increase in food prices and rising prices for crude oil and derivatives on world markets. However, core inflation re-accelerated during the second half of 2007 and in the course of 2008, reaching 10.3% year-on-year in July against a core inflation target range of 3-6% for the whole of 2008. By comparison, the headline rate of retail price inflation, followed more closely by the public, slowed to an annual average of 6.8% in 2007, compared with 12.7% a year earlier. Retail price inflation bottomed out at 4.5% year-on-year in May 2007 and then began to rise, ending on 10.1% year-on-year in December 2007. This upward trend continued in 2008 and retail price inflation reached 10.5% year-on-year in August 2008. To stem the rising inflationary pressures but also to help support the local currency, which had come under pressure on the foreign exchange market in early 2008 due to growing political uncertainty, the NBS increased the repo rate by 625 base points to 15.75% between December 2007 and May 2008. However, the expansion of monetary aggregates remained strong during 2007. The annual M3 growth rate, covering currency in circulation plus demand, time and savings deposits, accelerated during the second half of 2007, reaching 43% year-on-year in December. This trend reversed in 2008 when M3 growth slowed to 34% year-on-year in June. Credit growth also decelerated during the same period and stood at 32% year-on-year in June 2008, partially due to higher interest rates, also affected by global financial crises. Overall, while the new monetary policy framework of inflation targeting managed to tackle inflationary pressures, the real test of whether the set target can be achieved will come in 2008, as inflationary pressures have resurfaced and are contributing to a less stable environment for economic operators.

As far as foreign exchange rate policy is concerned, the NBS tightened administrative measures aimed at discouraging use of the euro within the economy and, at the same time, making the dinar more attractive. The NBS has, in principle, limited its intervention in the inter-bank foreign exchange market to situations of excessive daily fluctuations. However, during the second half of 2007 the NBS was prompted to intervene in support of the dinar which repeatedly came under depreciation pressure. This continued in early 2008 and the NBS sold EUR 393 million to support the dinar during the first four and a half months of the year. Following the formation of a pro-European government, the Serbian dinar (RSD) significantly regained strength. The EUR/RSD exchange rate fluctuated between RSD 75 and RSD 85 in 2007 and 2008. Overall, the volatility of the exchange rate increased, mainly because of political developments.

Fiscal policy remained expansionary in 2007 and 2008 ahead of presidential and parliamentary elections. Following the inflow of substantial privatisation proceeds in 2006, an increase in expenditure was achieved without significant new borrowing. According to the Government Finance Statistics (GFS) standard of accounting, the general government balance declined to 1.9% of GDP in 2007, from 1.5% of GDP a year earlier. Total expenditure remained high at 44% of GDP in 2007, compared with 43.9% a year earlier. Capital expenditure related to implementation of the National Investment Plan increased to 4.8% of GDP in 2007 from 3.9% in 2006. During the same period, current expenditure declined to 38.5% of GDP, from 39.5%, indicating some success on the part of fiscal policy in curbing constant pressures for higher current spending. However, labour costs and transfers continued to account for more than 60% of total public spending. Following the reform of the tax system in previous years, total revenue has stabilised at around 42% of GDP. 2007 saw a slight decline of revenue to 42.1% of GDP, from 42.4% in 2006. During the same period, public debt declined to 29.4% of GDP, from 36.2%, while net lending remained low, increasing marginally to 0.6%, from 0.5%. For 2008, a revised budget, which was adopted by the government in early October, foresees a deficit of the consolidated government budget to increase to 2.7% of GDP, compared to an initially planned deficit of 1.7%. This boosts expenditure to 45.4% of GDP, adding additional demand pressures on an economy showing already signs of overheating and growing macroeconomic imbalances. Overall, fiscal policy remained expansionary, ahead and after several rounds of elections, contributing to weakened macro-economic stability. The fiscal position remains vulnerable and fiscal policy would benefit from strong external anchors in the face of growing expenditures pressures and the ongoing financial crisis.

Overall, the macroeconomic policy mix was unbalanced, with insufficient fiscal restraint. The growing macroeconomic imbalances and external and financial vulnerabilities require a more restrictive policy response. Monetary policy would normally be expected to deliver adjustments which are unlikely to be attained with the announced fiscal policy. However, largely due to the high degree of euroisation, Serbia lacks an effective monetary transmission mechanism. This situation, coupled with the untested record of the central bank on its inflation targeting policy, may actually imply that the government will not be able to match fiscal policy adequately to containing rising external imbalances. The onus within the policy mix is therefore expected to remain on fiscal policy to address these imbalances. Overall, a too lax fiscal policy ahead of and after various elections has contributed to growing external imbalances and to inflationary pressures induced by domestic demand.

Interplay of market forces

Finalising the process of privatisation or, when appropriate, liquidation of socially- and State-owned enterprises is one of the key priorities of the European Partnership.

Privatisation of socially-owned companies continued in late 2007 and early 2008, in the form of both tenders and auctions. About 400 socially-owned companies were sold in 2007 (16 tenders, 283 auctions and over 100 companies sold through the sale of State-owned stakes on the capital market). This was followed by about 40 privatisations in the first two months of 2008, but the process slowed in March. The total number of companies privatised since the process started in 2002 had risen to over 2,200 by the end of February 2008. The number of firms that still need to be sold has consequently declined to about 700. The deadline for completing this process has been extended by one year until the end of 2008. A commission for the privatisation of public utilities has been set up and the government plans to privatise two State-owned companies by the end of the year.

Four large State-owned companies (the electricity company EPS, Telekom, Belgrade airport and the pharmaceutical company Galenika) are due to be put up for sale in the form of initial public offerings. Selection of a privatisation advisor has started. The first few companies are expected to be sold in 2008 and the whole process to be completed by 2010. A tender for sale of national flag carrier JAT Airways failed due to lack of interest. The oil conglomerate NIS has been sold as part of a framework agreement for supply of gas and oil with Russia. Serbia has entered with Fiat into a joint venture to restructure local car manufacturer Zastava into a modern production unit of the Fiat group. The question of privatisation of about 500 utilities at the level of local communities also remains open. Their restructuring and reorganisation have not yet begun and the plan for their privatisation remains undefined.

In December 2007, the law on the free distribution of shares in six State-owned companies to all adult citizens who did not benefit from earlier privatisations (15% of capital) and to ex-employees of these companies (2-5% of capital) was adopted. Under this law about 4 to 4.5 million citizens are expected to receive free shares in these large companies.

The share of the private sector remains at between 55% and 60% of total output. The private sector employs over 60% of the total number of employees. However, socially-owned, and in particular only partly restructured and non-privatised State-owned, companies still generate a large part of Serbia's output. Private companies remain relatively weak and have a major share in trade, but less so in production. This prevents development of competitive domestic products and burdens public finances. Overall, while there has been some progress with the privatisation of socially-owned companies, this is not the case with State-owned companies. As a result, a competitive and dynamic private sector has not yet been fully established.

Market entry and exit

As regards market entry and exit, some progress was made during the reporting period. In 2007, around 12,100 new companies and 48,700 new entrepreneurs were registered. In the first three months of 2008, an additional 3,100 new enterprises and 10,100 entrepreneurs were registered. However, the business environment has not improved substantially. With regard to market exit, implementation of the 2005 Bankruptcy Law has continued. About 25% of cases were closed within one year and another 20% within two years. However, the number of pending cases was still very high on 651 at the end of 2007. In addition, the bankruptcy unit of the Privatisation Agency has more than 360 socially-owned enterprises in its portfolio. Most of the cases have now been pending for three years or more and some for even more than a decade (mainly related to bankrupt socially-owned enterprises). The business environment has deteriorated, particularly in the areas of starting a business and construction permits. On the other hand, registering property has been facilitated. Overall, amid some progress, excessive bureaucratic requirements and complex legislation continue to hamper the business environment.

Legal system

As regards the legal system, no significant progress can be reported. Several reform-related laws have been held up and implementation of the existing laws is sometimes weak. The courts and administrative bodies lack the technical capacity and personnel to perform their activities properly and promptly. This has led to inconsistent implementation and very lengthy procedures, which frequently exceed the deadlines set by law. Widespread corruption as well as criminal activities affect the business climate and impact negatively the quality of public services. Overall, the weaknesses of the judiciary reduce legal predictability and undermine trust in the legal system among economic operators, in particular in effective enforcement of property rights.

Financial sector development

Lending activity of banks increased by 39%. Loans increased to 35% of GDP and 53% of the banking sector's total balance sheet. The share of total loans granted to the enterprise and household sectors stood at 58% and 40% respectively. Of the latter, 13% were used for house-building. Deposit activity of banks grew by 44%. The largest share of deposits was accounted for by the household sector (46%), followed by the enterprise sector (33%) and bank deposits (12%). Foreign currency deposits made up 67.7% of total deposits. Short-term time deposits (52%) predominated, followed by demand deposits (40%). Overall, financial intermediation continued to grow, but from a still relatively low level. However, the high degree of euroisation of assets and liabilities, combined with potential currency mismatches, could give rise to substantial balance-sheet risks for banks, households and corporations.

The number of majority State-owned banks remained unchanged at eight (out of a total of 34), while 20 banks are now majority-owned by foreign shareholders. Six banks were under majority ownership of domestic natural persons or legal entities. The five largest banks in terms of assets accounted for 46.5% of the total banking sector. In May 2008, the NBS issued a new licence to a non-EU bank for a green-field investment. Overall, while competition between banks is well established, privatisation of the State-owned banks has not advanced.

At the end of March 2008, 28.3% of the banking sector's total assets were classified as risky. The share of total credits in default in total outstanding debt stood at 4.4%, while the foreign exchange risk ratio of banks stood at 13.8%. The average capital adequacy ratio of the banking system stood at 27.7% and, consequently, remained well above the required minimum of 12% of risk-weighted assets for each bank. The profitability of the banking sector improved and the return on equity increased to 12.7%. Overall, the banking sector is profitable and remains generally sound. However, the high share of risky assets may indicate substantial financial vulnerabilities.

Following strong gains by both indexes at the Belgrade Stock Exchange during the first few months of 2007 (up by 88%), equity markets began to retreat and had lost all their early-2007 gains by August 2008.

At the end of May 2008, 21 insurance companies were operating in Serbia (including four green-field companies that received operating licences in 2007 and early 2008). The structure of the insurance sector is continuing to change with the privatisation of the socially-owned insurance companies and the arrival of new foreign investments. In addition, the second-biggest insurance company (DDOR of Novi Sad) was successfully privatised in 2007, when it was sold to an EU-based insurance company. As a result, foreign ownership of the insurance sector has increased strongly to 62.8% of total premium income in 2007 compared with 26.4% a year earlier. In the four years from 2004 to 2007, the premium income of non-life insurance almost doubled. In the case of life insurance it nearly tripled. At the same time, the insurance sector's share of capital in the total financial sector has increased to 6.9%. Overall, significant progress has been made with development of the non-banking financial sector.

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

Existence of a functioning market economy

Deteriorating macroeconomic stability, together with greater political uncertainty, contributed to creating a less stable and less predictable climate for decision-making by economic operators. The functioning of market mechanisms, which is required for efficient allocation of resources, was hampered by distortions, heavy State involvement in production of private goods and lack of competition.

Human and physical capital

Little progress can be reported on reform of the education system. The growing gap between demand for and supply of skilled employees is one of the main obstacles to increasing direct foreign investment and developing new branches of the economy. However, companies are responding to the growing shortages by becoming more proactive in offering personal/professional development and training incentives to new recruits. In addition, the number of human resource consultants and recruitment firms has increased. These not only provide support in locating people with the right skills, but also offer services like organisational and personnel development. Public universities continue to be overburdened with bureaucracy and curricula are often outdated. A number of private universities have emerged. Attitudes towards lifelong learning and mobility started to change only recently. Public education expenditure accounts for a relatively small 3.7% of GDP, well below EU levels. Overall, the economy has increasingly been suffering from a shortage of skilled employees, while supply has only gradually been building up in response.

In 2007, the investment ratio fell to 18% of GDP from 19.7% in 2006. Foreign direct investment fell sharply to EUR 1.6 billion or 5.1% of GDP from EUR 3.4 billion or 13.8% a year earlier. The sectors benefiting most from FDI were banking and the real estate business, followed by processing industry and wholesale and retail trade. Funds from the National Investment Plan (NIP) have been used for various infrastructure projects (Belgrade ring road and motorways in Southern Serbia), but also to stimulate foreign investment and job creation. The total budget for expenditure under the NIP stands at EUR 600 million for 2008. Overall, investment activity from domestic sources has been holding up well, while foreign investors have become more hesitant, primarily due to growing political uncertainty.

Sectoral and enterprise structure

Progress in selling State-owned companies was hampered by the election cycle and political developments. Restructuring and privatisation have been slow. The shift of economic activity towards the services sector is continuing, with services currently accounting for 54.7% of GDP. Manufacturing and construction account for 16.3% of GDP, while agriculture's share of GDP declined to 9.2%. About 50% of all employees are still working in State- and socially-owned enterprises. The informal sector remains large. Overall, the pace of structural adjustment of the economy is being held back by slow reforms.

State influence on competitiveness

Subsidies from the consolidated State budget accounted for 1.5% of GDP in 2007, down from 2.4% a year earlier. Relevant legislation on State aid control and the appropriate monitoring mechanism and authority are still missing. State-controlled monopolistic structures remain in place, such as the import ban on refined petroleum products to protect the domestic refinery industry from foreign competition. Overall, State influence on competitiveness has declined, but remains substantial.

Economic integration with the EU

Exports and imports of goods and services grew to 28% and 50% of GDP respectively in 2007, compared with 27% and 47% a year earlier. As a result, trade openness increased to 78% of GDP in 2007 from 74% in 2006. The EU remained Serbia's main trading partner. Exports and imports of goods and services to and from the EU increased to 56% and 54% of total exports and imports respectively, compared with 53% and 49% in 2006. Serbia's other main trading partners were Montenegro, Bosnia and Herzegovina, Russia and China. Overall, foreign trade has continued to grow and trade integration with the EU remains at a high level.

Net foreign direct investment from EU countries in Serbia remains unchanged at about EUR 2.3 billion. However, the EU's share of total net foreign direct investment in Serbia almost doubled to 116% in 2007 from 61% a year earlier. This large swing was caused by a strong inflow to Serbia from Norway in 2006, combined with a strong outflow from Serbia to Bosnia and Herzegovina in 2007, both of which distorted the figures for total net foreign direct investment in Serbia.

Standard indicators suggest a continuing deterioration in export price competitiveness. Real wages grew by 14.1%, i.e. by more than average labour productivity (estimated at 8.6%), implying a 5.4% increase in real unit labour costs. The nominal effective exchange rate of the dinar appreciated by 3.3%. In real effective terms, the dinar appreciated by 10.1%, as consumer prices grew faster on the domestic market than abroad.

7.4. CONCLUSIONS

The **economy** of Serbia continued to grow strongly. However, progress in macroeconomic stabilisation was mixed. The continuing reversal of fiscal consolidation added to macroeconomic risks. Structural reforms slowed down and the high level of unemployment, as well as rising inflationary pressures, remained major challenges.

As regards the **economic criteria**, Serbia made some progress towards establishing a functioning market economy. Further efforts are needed to enable Serbia to cope in the medium term with the competitive pressures and market forces within the Union.

Consensus on the fundamentals of a market economy was broadly maintained. The new monetary policy framework of inflation targeting enabled Serbia to meet the inflation targets in 2007. There was some progress in privatisation. Financial intermediation continued to grow from a still relatively low level. Significant progress was made with the development of the non-banking financial sector.

However, external imbalances widened, the quality of financing deteriorated, foreign debt rose, and the degree of macro-vulnerability increased also in the light of the global financial crisis. Fiscal policy remained expansionary, contributing to growing external imbalances and resurfacing inflationary pressures in 2008. Despite high economic growth rates in recent years, unemployment remained a major challenge. At the same time, the economy suffered increasingly from a shortage of skilled employees. There was some progress with regard to the privatisation of state-owned companies and banks. Foreign investment has been affected by the unstable political climate.

A competitive and dynamic private sector has not yet been fully established. Excessive bureaucratic requirements and complex legislation continued to hamper market entry and exit. Legal predictability and trust in the legal system remained limited, in particular as far as the effective enforcement of property rights were concerned. Although having declined, state influence on competitiveness remained high. The large informal sector is fuelled by a weak regulatory framework, by inappropriate tax and expenditure policies, and by weaknesses in law enforcement, including the fight against corruption and organised crime. It remains an important challenge as it reduces the tax base and the efficiency of economic policies.

8. KOSOVO (UN 1244)

8.1. INTRODUCTION

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

8.2. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The government of Kosovo presented an enhanced Medium Term Expenditure Framework for 2009-2011 (MTEF) which sets policy priorities, including economic growth and good governance . However, the consistency and reliability of the policies remain fragile. This was illustrated by the revised budget proposed in the mid-year budgetary review in July 2008, which deviated substantially from the MTEF, revealing an ad-hoc approach to fiscal policy. In addition, persistent lack of coordination between line ministries, failure to follow procedures established in relevant laws and weak governance of State enterprises continue to damage the overall economic environment. The economy and economic policy formulation were affected by the general elections in November 2007, by the declaration of independence in February 2008 and by the lack of clarity about the magnitude and sequencing of the international presence during the transition. On 10 July 2008, Kosovo formally applied for membership of the International Monetary Fund and, subsequently, of the World Bank. Overall, political consensus on the fundamentals of market-oriented economic policies has been maintained, but the strategic medium-term approach has yet to be incorporated into government action.

Macroeconomic stability

Shortcomings in statistics continue to hamper comprehensive assessment of the economic situation in Kosovo. Real GDP grew by an estimated 4.4% in 2007 after an increase by 3.9% in 2006 . Consumption by private households increased by almost 10% in nominal terms. Public consumption showed a different picture, as government wages grew by 2.5% and public consumption of goods and services by 1.4%. General government investment expenditure fell by almost 10% in 2007, as only 71% of budgeted investment was actually spent . Donor-financed investment shrank by 7.7%, taking its share of total investment down to 4% from 5.5% in 2006. Total investment itself stood at 27% of GDP in 2007, up from 23% in 2006. Economic activity is increasingly determined by domestic factors and private sector dynamism, albeit remaining at a moderate level. Together with weak implementation of the capital budget, the unreliable energy supplies continued to be a major drag on investment and growth. According to IMF estimates, GDP per capita in 2007 stood at roughly €1,600 which is around 5,5% of the EU-27 average . Overall, growth is slowly picking up from a moderate level while the unreliable energy supply, with several and lengthy power cuts a day, remains the single most serious restraint on growth.

The coverage ratio of exported to imported goods is still very low, reflecting the lack of export capacity and competitiveness, despite an increase in the 12-month moving average from 8.5% in 2006 to 10.9% in July 2008. The trade deficit widened further to 41% of GDP in 2007, compared with 37% in 2006. This trend continued into 2008, though at a slower pace. In the first seven months of 2008, exports of goods increased by 63% and imports by 27% compared to the same period a year earlier, bringing the trade deficit (goods only) to an estimated 42% of GDP. The current account deficit – including foreign assistance – increased from 12.2% of GDP in 2006 to 17.4% in 2007. It was mainly financed by foreign direct investment (FDI) inflows. On the back of accelerated privatisation activity and investments in the second mobile operator (IPKO) and the banking sector throughout 2007, FDI rose to 12.6% of GDP after 8% in 2006. However, a significant part of the financing remained unexplained , pointing to a large proportion of unrecorded financial flows. Workers' remittances stood at 12.9% of GDP in 2007 after 11.6% in 2006. The fall of net foreign assets of the commercial banking sector by 16% during the first half of 2008 indicates decreasing capital inflows to Kosovo. Overall, the external accounts of Kosovo remain precarious.

The poor availability and reliability of official employment data make it difficult to analyse labour market developments. At the end of 2007, the number of registered unemployed had increased by 2.6% compared with 2006 and.. 60% of the unemployed are unskilled, 47% are female and the share of long-term unemployed remains extremely high (93%). After a slight increase during the first months of 2008, the officially recorded number of unemployed almost returned to its end-2007 level over the summer months. In July it stood at 335,920 persons, up 0.4% compared to December 2007 and 0.9% compared to July 2007. The results of the Labour Force Survey 2007 revealed an unemployment rate of 43.6% (male 38.5%, female 55.2%), an activity rate of 46.5% (male 65.2%, female 28.3%) and an employment rate of 26.2% (male 40.1%, female 12.7%). Some 30,000 young people enter the labour market every year. At current growth rates, the economy cannot absorb this additional young and growing labour force. Also, the fact that the economy is starting from a weak productive base, the ongoing structural changes, partly linked to the privatisation process, and poorly defined and administered eligibility criteria for social transfers conservational contribute to sustaining the existing level of unemployment. However, partly due to the significant size of the informal economy, changes in registered unemployment may not correctly reflect the actual dynamics of the economy. Overall, registered unemployment remains very high.

Average yearly consumer price inflation rose to 4.4% in 2007 after 0.6% in 2006 and rose to 12.4% in the first eight months of 2008. Inflation picked up strongly in the second half of 2007, with year-on-year rates consistently above 10% since October 2007 and rising to 14% between May and July 2008. This development was primarily driven by food prices, which make up almost half of the consumer basket, and transport. Mostly due to a base effect, the annual inflation rate came down to 7.8% in August 2008. Inflationary pressures decreased due to the relaxation in international energy and food price developments. In 2007, broad money widened by 23.3% and the stock of outstanding loans to the private sector by 40%. To sum up, after years of low inflation, price tensions resurfaced, triggered by commodity price increases, even though they have eased recently.

Kosovo has started to earmark funds for notional debt servicing and to set up a liquidity and stabilisation reserve in its medium-term budget planning. In 2007, budget volatility increased, with revenue strongly exceeding and capital spending falling short of budgeted figures. This resulted in accumulation of substantial cash reserves and an unfavourable policy mix. Implementation of the 2007 budget produced (i) one-off revenue of €75 million from the sale of a mobile telephone licence; (ii) higher than planned revenue collection, thanks mostly to buoyant border tax receipts; and (iii) low capital spending. Together, these factors led to unintended strong fiscal tightening in 2007, with a surplus of 7.2% of GDP, reflecting the poor quality of budget planning and implementation. The 2008 budget is expansionary and diverges from the fiscal rule that real current primary expenditure should rise by not more than 0.5% year-on-year. Instead, it is set to rise by probably more than 10% over last year's outturn. Budgeted capital expenditure is almost triple the 2007 outcome and the trend was accentuated in the July 2008 mid-year budgetary review, while the MTEF already acknowledges that actual outcome will probably fall short of this figure by some 30%. Current budget execution figures suggest an even higher shortfall, as capital expenditures continue to underperform, reaching only 20% of the annual plan in September, while revenues performed roughly as expected. Overall, the budget is not an efficient instrument of fiscal policy and does not contribute to the predictability of economic developments. Instead, it just responds to ad-hoc spending pressures.

Kosovo continues to rely on the euro as its currency in use. In the absence of an autonomous monetary policy, this leaves the budget as the core tool for macroeconomic policy in Kosovo. However, due to the poor budgetary planning and implementation, as displayed by the unintendedly strong fiscal consolidation in 2007, followed by an expansionary budget plan in 2008, the overall policy mix remains inadequate and budget volatility has increased.

Interplay of market forces

In 2007, the private sector's share of overall consumption, investment and imports increased further. Private investment rose by an estimated 37% in 2007, up from 26% in 2006. Privatisation continued at a brisk pace until late 2007, when it came to a sudden standstill after a ruling by the Special Chamber of the Kosovo Supreme Court called into question the method of privatisation. These concerns have been partly addressed in a new Law on the Privatisation Agency of Kosovo (PAK) and the privatisation process slowly resumed after the summer. However, further legal issues remain to be resolved and the agency has yet to come into operation. All publicly owned enterprises were incorporated by the end of 2007 and new legislation allows their privatisation . Overall, the expansion of the private sector continued in 2007, but entered an uncertain phase in 2008, marked by the standstill in the privatisation process in the first half of the year.

Market entry and exit

The number of registered businesses in Kosovo stood at approximately 86,000 in June 2008. However, a substantial share of these are not active. Improvements have been made in the "one-stop shop" facilities for business registration, but fixed costs for doing business, such as work and construction permits, remain high. The unreliable energy supply, limited access to finance, corruption and poorly defined property rights hinder market entry and exit. With the aim of facilitating exits, the Law on bankruptcy has been approved. Overall, difficult and costly enforcement of contracts aggravates access to finance and is continuing seriously to hamper the business environment.

Legal system

In June 2008, the Kosovo Property Agency (KPA) started to deliver the first decisions taken by the Kosovo Property Claims Commission (KPCC) to claimants. The KPCC has adjudicated 8,329 out of 39,589 property claims submitted to the KPA. However, in June the government of Serbia subsequently decided to suspend the offices of the KPA in Belgrade, Kragujevac and Niš, stating that the KPA had failed to protect the rights of Serb citizens whose property in Kosovo had been illegally occupied by third parties. Corruption, criminal activities and uncertainty over property rights remain major impediments to economic development. In general, use of courts for enforcement of contracts remains underdeveloped, while at the same time courts continue to face a heavy backlog of pending cases.

Financial Sector development

The financial sector in Kosovo is continuing to grow. Seven commercial banks, nine insurance companies and two pension funds are operating in Kosovo. Four new banks entered the market in 2007 and 2008. So far, the international financial crisis has not had a material impact on the financial sector in Kosovo, as local banks have no direct exposure to sub-prime first-wave effects and are in a favourable liquidity position. However, currently unwinding second-wave effects may have an impact via the mostly foreign mother companies of local banks. In May 2008, the Central Bank of Kosovo signed Memoranda of Understanding with the Turkish and Croatian financial sector supervisory authorities, adding to similar frameworks in place with the respective institutions of other countries from the region.

The banking sector holds 88% of financial sector assets and is dominated by foreign banks and remains highly concentrated, with the three largest banks holding 83% of the total assets. Its profits rose by 68% in 2007. The degree of financial intermediation in Kosovo increased further, though from a still modest level. The share of banking sector assets in GDP grew from 37% in 2006 to 43% in 2007. The volume of loans increased from 21% of GDP in 2006 to 27% in 2007. Loans grew by 40% year-on-year, mainly financed from the increase in deposits. In the first half of 2008, the loans to deposit rate increased to 85%. This high rate signals rising liquidity problems in the economy. Additionally, loans are predominantly long-term, while deposits are short-term, revealing a maturity mismatch. The quality of the loan portfolio in Kosovo's banking sector is showing some signs of deterioration: non-performing loans accounted for 4.1% of the total loan portfolio (0.4 percentage points up from 2006). However, profitability and liquidity indicators for the first half of 2008 remain favourable, even though they are slightly deteriorating. The interest rate spread between deposits and loans is very wide and shows only a slow downward trend (decreasing to 11.3 percentage points in 2007 from 11.8 in the previous year). Sectors do not enjoy equal access to finance: The vast majority of loans goes to trade (57.6% in the first half of 2008, down from 61% in the same period 2007), followed by services (17.6%, up from 14.9%) and industry and energy (13.4%, up from 11.8%). The ineffective enforcement of creditor rights and of contracts in Kosovo pushes up costs for financial institutions and undermines the value of collateral.

The insurance market is also dominated by foreign companies and is still very small with assets accounting for only 2% of GDP in 2007. A set of risk-based capital and reserves requirements for the insurance sector was devised by the central bank to strengthen the capacity of the industry. Also, a legal framework has been established for life insurance products and for liberalisation of tariffs. Overall, the financial sector remains profitable and financial intermediation has deepened further, though at a low level. Access to finance is still uneven and hindered by weak enforcement of contracts and high borrowing costs.

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

Existence of a functioning market economy

In general, Kosovo has developed an appropriate legislative and institutional framework for a functioning market economy. However, implementation and enforcement of this framework remain weak. One prominent issue is electricity, where theft and non-payment of bills continue to be tolerated and contribute to inefficient use of a scarce resource. Energy supplies also suffer from a poor governance structure and weak management of the energy provider (KEK) combined with underinvestment, despite constant high subsidies from the budget, vested interests and weak political will to change the situation. Additional factors, such as the wide-spread tax evasion and corruption together with extensive use of undeclared labour, lead to a price system where several prices for the same goods or service co-exist, with negative consequences for overall market efficiency and transparency. Growth in 2007 is considered to be due entirely to the private sector's resilience in an environment of low public investment and further declining donor support. Overall, uncertain property rights and poor enforcement of contracts, corruption and insufficient energy supply as a result of weak governance of the provider KEK and infrastructure continue to weigh down the competitiveness of Kosovan businesses, the business climate and the reliability of market allocation mechanisms.

Human and physical capital

Kosovo remains affected by lack of adequate education facilities and poor-quality teaching. The overall enrolment rate in education has shown no significant increase in recent years. It is especially low in secondary and higher education, and drop-out levels are high. The share of education in overall budget expenditure increased to 17.3% in the first half of 2008. Active labour market policies such as vocational training continue to face severe capacity constraints. For lack of physical facilities and trainers, only a small fraction of the annual age cohort arriving on the labour market benefit from such measures. To address these constraints, a regional centre for professional qualifications has been built in Priština/Prishtinë.

The transport infrastructure (roads and railways) in Kosovo is limited in scope and condition. It is not well connected with regional networks, and maintenance expenditures have been inadequate even though some upgrading of the road infrastructure has started in the Priština/Prishtinë area and concerning the regional connections to Skopje and Peja. Road density stands at only 3.3 km per 1,000 inhabitants and rail connections with Serbia have been difficult after Kosovo's declaration of independence.

Mobile telephone penetration has increased rapidly and had reached an estimated 50% by mid-2008. Partly due to the entry of the second mobile telephone operator, the high-speed telecommunications infrastructure is improving, the range of products is widening and prices are falling. Overall, the weak technology base (combined with lack of price competitiveness), the weak state of physical infrastructure and the small pool of qualified human capital remain major impediments to a well-functioning and competitive market economy.

Sectoral and enterprise structure

Regulatory authorities have been set up for all major network and commodity industries, but their capacity remains weak. In several instances, the potential positive effects of liberalisation have not been able to materialise due to weak corporate governance or, in the case of the mining sector, continued social unrest. Kosovo cannot yet trade energy on a level playing field with its neighbours due to unfinished integration into regional electricity trade agreements. Generation and distribution of electricity are still bundled in the poorly performing energy provider KEK. There have been few changes in the enterprise structure, which remains dominated by micro-enterprises. However, development of the financial sector has helped to increase the share and dynamism of the services sector. Trade data for 2008 point to some structural improvement in the food processing sector, in terms of import substitution of processed foodstuffs. The informal sector remains large. Overall, there has been little change in the sectoral structure of the economy.

State influence on competitiveness

In 2007, cash subsidies to public entities remained stable at the 2006level. But in 2008 this level had already been reached during the first six months . Although the government did not intervene as bluntly as in 2007, inaction against wide-spread electricity theft remains a huge indirect subsidy in addition to subsidies paid from the budget, and it continues to undermine the credibility of the independent electricity regulator. The inaction of the authorities is also eroding competitiveness, especially of medium-sized to large producers. These cannot resort to the informal economy to the same extent as micro-enterprises and small businesses which mainly operate in the service and the trade sector. Consequently, the weak administration and rule of law are contributing to a rigid business structure which in turn makes it difficult for the private sector to achieve important economies of scope and/or scale. Overall, continued direct and indirect State subsidies, combined with a poor level and quality of public services, are hampering private-sector competitiveness.

Economic integration and convergence with the EU

The openness of the economy, measured by the value of imports plus exports in goods and services as a percentage of GDP, increased to 62% in 2007, up from 56% in 2006 . Base metals and base metal products continued to account for almost half of goods exports in 2007 and their share increased further to 66% in the first seven months of 2008. Exports of goods during this period were up 63% compared with the same period in 2007, with exports to the EU almost doubling. Imports of goods increased by 21% in 2007 and by 27% in the first seven months of 2008. Mineral products (mainly oil) remain the largest import category (21% of total imports during the first seven months of 2008).

The CEFTA and EU Member States continue to be the two main trading partners for Kosovo with equal shares of 37.5% of total trade in the first half of 2008. The share of exports bound for the EU increased from 38% in 2006 to 42% in 2007 and further to 50% in the first seven months of 2008. The EU's share of total imports remained at around 35-36%. The real effective exchange rate based on the consumer price index started to increase steadily in mid-2007, after a modest depreciation in 2006 by 2.8% . Clearly, the recorded export performance was not spurred by increasing price competitiveness. Overall, economic integration with the EU has increased.

8.4. CONCLUSIONS

The **economy** of Kosovo has grown at a higher rate than in previous years. However, growth remains too low to absorb the additional labour supply offered by a young and growing population. Macroeconomic performance was marked by volatile budget outcomes, growing inflation, very high unemployment and external imbalances. The consensus on economic policy essentials was weakened by the government's focus on political developments and by increased budget volatility. Economic development is further hampered by a standstill in privatisation, erratic energy supply, weak rule of law, limited productive capacity, poor infrastructure and inadequate education.

As regards the **economic criteria**, Kosovo has made very limited and uneven progress towards establishing a functioning market economy. A continued drive for reform and sizable investments in infrastructure and education are necessary to enable Kosovo to cope over the long term with competitive pressure and market forces within the Union.

Overall, economic policies remained market-oriented. The government presented a comprehensive Medium-Term Expenditure Framework 2009-2011 (MTEF). Growth slightly picked up compared with previous years and economic activity is increasingly driven by private-sector dynamism. Foreign direct investment rose. Financial intermediation in Kosovo deepened further. Some procedures for market entry and exit by businesses have been smoothened and economic integration with the EU continued.

However, the consistency and reliability of economic policies were weakened in an uncertain political environment. Stronger fiscal consolidation than planned in 2007 was followed by an expansionary budget plan in 2008, leading to increased budget volatility. The budget is not used as an efficient instrument of fiscal policy and does not contribute to the predictability of economic developments. Instead, it responds to ad hoc spending pressures. Inflation resumed and unemployment remained very high. The external accounts remained precarious, as the trade deficit widened further and Kosovo continued to lack export capacity.

Privatisation was temporarily suspended in 2008, following a ruling by the Supreme Court, which called into question the method of privatisation and the transition from the UNMIK Kosovo Trust Agency (KTA) to the Privatisation Authority of Kosovo. The lack of quality statistics remained a serious obstacle for designing good policies. Major constraints for private-sector development include the unreliable energy supply, a mismatch of skills and poor physical infrastructure. Companies have uneven access to finance and the interest-rate spread between deposits and loans remained very high. The large informal sector is fuelled by a weak regulatory framework, by inappropriate tax and expenditure policies and by weaknesses in law enforcement, including the fight against corruption and organised crime. This remains an important challenge, as it reduces the tax base and the efficiency of economic policies.

ANNEX 1
Abbreviations

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

ANNEX 2
Statistical Annex

STATISTICAL DATA (as of 29 September 2008)

Croatia

Basic data	Note	**2003**	**2004**	**2005**	**2006**	**2007**
Population (thousand)		4 443e	4 442e	4 444e	4 443e	4 441e
Total area of the country (km²)	1)	56 594	56 594	56 594	56 594	56 596
National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)	2)	198 422	214 983	231 349	250 590	275 078
GDP (million euro)	2)	26 216	28 677	31 263	34 221	37 497
GDP (euro per capita)	2)	5901e	6456e	7035e	7702e	8443e
GDP (in Purchasing Power Standards (PPS) per capita)		9 800e	10 600e	11 100e	11 700e	:
SI: GDP (in PPS per capita, EU-25=100)		45.6e	47.0e	47.9e	48.1e	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)	2)	5.3	4.3	4.3	4.8	5.6
SI: Employment growth (national accounts, % change on previous year)		0.6	:	:	:	:
Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)	4)	116.3	120.6	126.7	132.4	139.8
Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		1.8	2.1	3.3	3.2	:
Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-1 889	-1 434	-1 976	-2 696	-3 226
Foreign Direct Investment (FDI) in the reporting economy (million euro)		1 762	950	1 468	2 745	3 597
Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)	5)	-6.2	-4.8	-4.0	-3.0	-2.6
SI: General government debt, relative to GDP (%)		40.4	42.2	44.0	40.9	38.1
Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		75.8	80.0	82.4	85.5	87.8
Gross foreign debt of the whole economy, relative to total exports (%)		151.3	161.0	168.6	172.2	179.2
Value of reserve assets (including gold) (million euro)		6 554	6 436	7 438	8 725	9 307
External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		68.3	65.8	63.3	64.3	60.9
Share of imports from EU-27 countries in value of total imports (%)		73.3	71.0	67.9	67.2	64.8
Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)	9)	62.4	63.7	63.3	62.6	63.2
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)	9)	53.4	54.7	55.0	55.6	57.1
SI: Unemployment rate: share of labour force that is unemployed (%)	9)	14.1	13.6	12.6	11.1	9.6

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Land area.
2. For 2005-2007, data is based on quarterly values.
4. Gross series; include NACE Sections C to E.
5. GFS 1986 basis. Privatisation revenues are excluded and reclassified to the financing of the balance.
9. For 1998-2001, data refer to the second half of the year; in 2007, data refer to the annual average of quartely data.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Macedonia, the former Yugoslav Republic of

Basic data	Note	2003	2004	2005	2006	2007
Population (thousand)	1)	2 024	2 030	2 035	2 039	2 042
Total area of the country (km²)		25 713	25 713	25 713	25 713	25 713

National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)		251 486	265 257	286 619	310 915	:
GDP (million euro)		4 105	4 325	4 676	5 081	:
GDP (euro per capita)		2029e	2130e	2298e	2491e	:
GDP (in Purchasing Power Standards (PPS) per capita)		5 300.0	5 600.0	6000.0e	6400.0e	:
SI: GDP (in PPS per capita, EU-25=100)		24.6	25	25.8e	26.3e	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		2.8	4.1	4.1	4	:
SI: Employment growth (national accounts, % change on previous year)		-2	-2	2.1	2.3	:

Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		96.1	94	100.6	104.2	108

Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		1.2	-0.4	0.5	:	:

Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)	2)	-168	-363	-121	-45	-171
Foreign Direct Investment (FDI) in the reporting economy (million euro)	2)	100	261	77	345	239

Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		0.1	0.4	0.2	-0.5	0.6
SI: General government debt, relative to GDP (%)		39.1	36.6	39.5	33.1	25.8

Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)	3)	35.9	47.9	53.9	49.1	:
Gross foreign debt of the whole economy, relative to total exports (%)	3)	95.7	121.2	122.3	104.8	89.3
Value of reserve assets (including gold) (million euro)		715	717	1 123	1 417	1 524

External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		58.9	60.3	56.9	61.3	65.2
Share of imports from EU-27 countries in value of total imports (%)		60.3	60.8	54.7	53	49.6

Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		61.3	58.8	60.7	62.2	62.8
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)		38.5	36.8	37.9	39.6	40.7
SI: Unemployment rate: share of labour force that is unemployed (%)		36.7	37.2	37.3	36	35

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat. Break in series 2003.
2. For the period 1998-2002, the values in Euro are calculated using the annual average exchange rate; from 2003 the values in Euro are calculated on the basis of the current exchange rate.
3. For the period 1999-2003 external debt data are calculated according to the old methodology, with partial data coverage; since 2004 Gross Foreign Debt data are prepared according to the External Debt Statistics Guide, with full data coverage.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Turkey

Basic data	Note	2003	2004	2005	2006	2007
Population (thousand)	1)	69 770	70 692	71 610	72 520	69 689b
Total area of the country (km²)	2)	783 562	783 562	783 562	783 562	783 562
National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)		454 781	559 033	648 932	758 391	856 387
GDP (million euro)		269 322	314 304	387 655	419 013	480 281
GDP (euro per capita)		3 860	4 446	5 413	5 778	6 892b
GDP (in Purchasing Power Standards (PPS) per capita)		7 000.0	8 100.0	8 800.0	9 700.0e	10 300.0be
SI: GDP (in PPS per capita, EU-25=100)		34.1	37.5	39.2	41.3e	41.8e
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		5.3	9.4	8.4	6.9	4.5
SI: Employment growth (national accounts, % change on previous year)		:	:	:	:	:
Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		108.7	119.3	128.7	136.3	143.6
Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		25.3	10.6	8.2	9.6	8.8
Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-6 643	-11 601	-17 794	-25 401	-27 547
Foreign Direct Investment (FDI) in the reporting economy (million euro)		1 548	2 239	8 063	15 920	16 202
Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		-9	-4.5	-0.6	-0.1	-1.2
SI: General government debt, relative to GDP (%)		67.3	59.2	52.3	46.1	38.8
Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		47.3	41.2	35	39	37.5
Gross foreign debt of the whole economy, relative to total exports (%)		217.5e	183.8e	168.0e	174.9e	:
Value of reserve assets (including gold) (million euro)		28 134	27 654	44 277	48 116	52 058
External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		58.3	57.9	56.4	:	:
Share of imports from EU-27 countries in value of total imports (%)		50.6	49.3	45.2	:	:
		-72.7	-1431.9	-231.3	25.5	-335.1
Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		51.1	51.5	51.3	51.1	51
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)		45.5	46.1	45.9	45.9	45.8
SI: Unemployment rate: share of labour force that is unemployed (%)		10.5	10.3	10.3	9.9	9.9

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat. Break in serie in 2006.
2. Including lakes.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Albania

Basic data	Note	2003	2004	2005	2006	2007
Population (thousand)	1)	3 103	3 120	3 135	3 149	3 153
Total area of the country (km²)		28 750	28 750	28 750	28 750	28 750

National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)		694 098	750 785	814 797	891 000	:
GDP (million euro)		5 048	5 881	6 561	7 239	:
GDP (euro per capita)		1 627	1 885	2 093	2 299	:
GDP (in Purchasing Power Standards (PPS) per capita)		:	:	:	:	:
SI: GDP (in PPS per capita, EU-25=100)		:	:	:	:	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		5.8	5.7	5.8p	5.5p	:
SI: Employment growth (national accounts, % change on previous year)		:	:	:	:	:

Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		:	:	:	:	:

Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		3.3	2.2	2	2.5	3.1

Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-350	-340	-589	-471	-832p
Foreign Direct Investment (FDI) in the reporting economy (million euro)		157	267	209	250	466p

Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		-4.9	-5.1f	-3.4	-3.3	:
SI: General government debt, relative to GDP (%)		61.5	58.3	55.3	59.7	:

Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		21.1	19	16.6	16.9	:
Gross foreign debt of the whole economy, relative to total exports (%)	2)	103.5	86.5	73	:	:
Value of reserve assets (including gold) (million euro)		908	1 103	1 144	1 429	1 564

External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		93.8	90.9	93.2	:	:
Share of imports from EU-27 countries in value of total imports (%)		74.3	70.5	67.2	:	:

Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)	5)	60.1	58.8	57.8	53.7	:
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)	5)	51.1	50.3	49.7	48.7	:
SI: Unemployment rate: share of labour force that is unemployed (%)	5)	15	14.4	14.1	13.8	:

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat. Break in series in 2000.
2. Debt Outstanding Disbursed (DOD) cumulative stock covering external public debt and external publicly guaranteed debt, but excluding IMF credits. Total exports are calculated according to the national accounts concepts.
5. Administrative data; unemployment refers to registered unemployment.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Bosnia and Herzegovina

Basic data	Note	2003	2004	2005	2006	2007
Population (thousand)	1)	3 830	3 837	3 843	3 843	3 844
Total area of the country (km²)		51 209	51 209	51 209	51 209	51 209

National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)	2)	14505b	15 786	16 927	19 121	21 641p
GDP (million euro)	2)	7416b	8 071	8 655	9 777	11 065p
GDP (euro per capita)	2)	1935b	2 103	2 252	2 544	2 880p
GDP (in Purchasing Power Standards (PPS) per capita)		:	:	:	:	:
SI: GDP (in PPS per capita, EU-25=100)		:	:	:	:	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		:	6.3	3.9	6.7	6.8p
SI: Employment growth (national accounts, % change on previous year)		:	:	:	:	:

Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		118.0e	132.8e	144.7e	159.3e	170.4e

Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)	3)	0.6	0.4	3.8	6.1b	1.5

Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-1 439	-1 319	-1 555	-817	-1 401
Foreign Direct Investment (FDI) in the reporting economy (million euro)		338	567	478	564	1 478

Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		0.7	1.6	2.4	2.9	1.3
SI: General government debt, relative to GDP (%)		27.7	25.5	25.6	21.3	18.3

Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		:	:	:	:	:
Gross foreign debt of the whole economy, relative to total exports (%)		:	:	:	:	:
Value of reserve assets (including gold) (million euro)	6)	1 428	1 779	2 160	2 787	3 393

External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		53.4	54.2	53.8	:	:
Share of imports from EU-27 countries in value of total imports (%)		58.5	53	51.9	:	:

Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		:	:	:	51.3	52.2
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)		:	:	:	35	36.8
SI: Unemployment rate: share of labour force that is unemployed (%)	8)	41.6	41.8	43.9	31.1b	29

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in series

1. Source: Eurostat.
2. For 2000-2002, the value of non-observed economic activities is not included, thus values are estimated.
3. Until 2006, the growth rate of retail prices is presented, from 2006 onwards growth rate if the consumer price index (CPI) is used.
6. Data as of 31 December; reserve assets do not include gold.
8. Before 2006 data based on administrative sources, from 2006 onwards data based on the labour force survey.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Montenegro

Basic data	Note	**2003**	**2004**	**2005**	**2006**	**2007**
Population (thousand)	1)	619	621	623	624	625
Total area of the country (km²)	2)	13 833	13 833	13 812e	13 812	13 812p
National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)	3)	:	:	:	:	:
GDP (million euro)		1 510	1 670	1 815	2 148p	:
GDP (euro per capita)		2435e	2684e	2912e	3 443p	:
GDP (in Purchasing Power Standards (PPS) per capita)		:	:	:	:	:
SI: GDP (in PPS per capita, EU-25=100)		:	:	:	:	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		2.5	4.4	4.2	8.6p	:
SI: Employment growth (national accounts, % change on previous year)		:	:	:	:	:
Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		102	116	114	115	115
Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		:	:	:	:	:
Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-102	-120	-154	-531	-1 008p
Foreign Direct Investment (FDI) in the reporting economy (million euro)		44	53	393	644	1 008
Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		:	:	:	:	:
SI: General government debt, relative to GDP (%)		:	:	:	:	:
Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		:	:	:	:	:
Gross foreign debt of the whole economy, relative to total exports (%)		:	:	:	:	:
Value of reserve assets (including gold) (million euro)		50	60	173	310	490
External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		:	:	53.5	62.2	59
Share of imports from EU-27 countries in value of total imports (%)		:	:	45.3	45.4	43.6
Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)	7)	58.9	51.7	49.9	49	53
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)	7)	36.2	37.4	41	41	43
SI: Unemployment rate: share of labour force that is unemployed (%)		22.7	27.7	30.3	29.6	19.3

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat.
2. Total land includes: agricultural area, forests and non-agricultural land.
3. No official national currency exists. Euro is the currency in use.
7. Age group refers to persons aged 15 or more years.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Serbia

Basic data	Note	**2003**	**2004**	**2005**	**2006**	**2007**
Population (thousand)	1)	7 491	7 470	7 456	7 425	7 382
Total area of the country (km²)		77 474	77 474	77 474	77 474	77 474

National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)	2)	1 171 564	1 431 313	1 747 459	2 042 048p	:
GDP (million euro)	2)	18 009	19 724	21 077	24 255p	:
GDP (euro per capita)	2)	2 407	2 643	2 833	3 273	:
GDP (in Purchasing Power Standards (PPS) per capita)		:	:	:	:	:
SI: GDP (in PPS per capita, EU-25=100)		:	:	:	:	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)	2)	2.5	8.4	6.2	5.7	7.5e
SI: Employment growth (national accounts, % change on previous year)	2)	-4	1.2	-3.9	-1	:

Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		98.8	105.9	106.7	111.7	115.8

Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		9.9	11.4	16.2	11.7	7

Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-1 255	-2 306	-1 788	-3 157	-5 021
Foreign Direct Investment (FDI) in the reporting economy (million euro)		:	:	:	:	:

Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		:	:	0.8	-1.5	-1.9
SI: General government debt, relative to GDP (%)		64.3	53.3	50.1	33.2	28.7e

Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		60.3	52.5	62	61.4	59.5
Gross foreign debt of the whole economy, relative to total exports (%)		282	231.8	246.3	213.4	206.8
Value of reserve assets (including gold) (million euro)		3 548	3 780	5 525	9 593	10 897

External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)	3)	53.9	56.6b	58.7	57.5	57.5
Share of imports from EU-27 countries in value of total imports (%)	3)	58.4	58.2b	54.7	54.4	55

Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		68.9	66.4	65.2	63.6	63.4
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)		57.9	53.4	51	49.9	51.5
SI: Unemployment rate: share of labour force that is unemployed (%)		16	18.7	21.1	21	18.3

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat.
2. From 1999 onwards, excluding Kosovo and Metohia.
3. From January 2004 onwards the Uniform Customs Document harmonized with EU regulations has been used.

Source: Eurostat

STATISTICAL DATA (as of 29 September 2008)

Kosovo under United Nations Security Council Resolution 1244/99

Basic data	Note	**2003**	**2004**	**2005**	**2006**	**2007**
Population (thousand)	1)	2 016	2 041	2 070	2 100	2 127
Total area of the country (km²)		10 887	10 887	10 887	10 887	:
National accounts	Note	2003	2004	2005	2006	2007
Gross domestic product (GDP) (million national currency)		:	:	:	:	:
GDP (million euro)	2) 3)	1 797p	3 007p b	3 068p	3 192p	:
GDP (euro per capita)		905p	1 473p b	1 482p	1 520p	:
GDP (in Purchasing Power Standards (PPS) per capita)		:	:	:	:	:
SI: GDP (in PPS per capita, EU-25=100)		:	:	:	:	:
SI: Growth rate of GDP (national currency, at constant prices, % change on previous year)		3.1p	:	:	:	:
SI: Employment growth (national accounts, % change on previous year)		:	:	:	:	:
Industry	Note	2003	2004	2005	2006	2007
Industrial production volume index (2000=100)		:	:	:	:	:
Inflation rate	Note	2003	2004	2005	2006	2007
SI: Consumer price index (CPI), (total, % change on previous year)		0.3	-0.8	-2.1	-1.5	2.8
Balance of payments	Note	2003	2004	2005	2006	2007
Balance of payments: current account total (million euro)		-284	-317	-380	-389	-536
Foreign Direct Investment (FDI) in the reporting economy (million euro)		:	19	80	250	422
Public finance	Note	2003	2004	2005	2006	2007
General government deficit/surplus, relative to GDP (%)		2.2	2.7	:	:	:
SI: General government debt, relative to GDP (%)		:	:	:	:	:
Financial indicators	Note	2003	2004	2005	2006	2007
Gross foreign debt of the whole economy, relative to GDP (%)		:	:	:	:	:
Gross foreign debt of the whole economy, relative to total exports (%)		:	:	:	:	:
Value of reserve assets (including gold) (million euro)		77	79	107	102	167
External trade	Note	2003	2004	2005	2006	2007
Share of exports to EU-27 countries in value of total exports (%)		:	29.4	38.4	38	42
Share of imports from EU-27 countries in value of total imports (%)		:	39.5	37.3	34.4	36.3
Labour market	Note	2003	2004	2005	2006	2007
Economic activity rate (15-64): share of population aged 15-64 that is economically active (%)		50.3	46.2	49.2	52.3	46.8
SI: Employment rate (15-64): share of population aged 15-64 that is in employment (%)		25.3	27.7	28.5	28.7	26.2
SI: Unemployment rate: share of labour force that is unemployed (%)		49.7	39.7	41.4	44.9	43.6

SI: Structural Indicator
e : estimate
f : forecast
p : provisional
b : break in serie

1. Source: Eurostat.
2. Source: SOK provisional data for 2004-2006 (at current prices).
3. No official national currency exists. Euro is the currency in use.

Source: Eurostat