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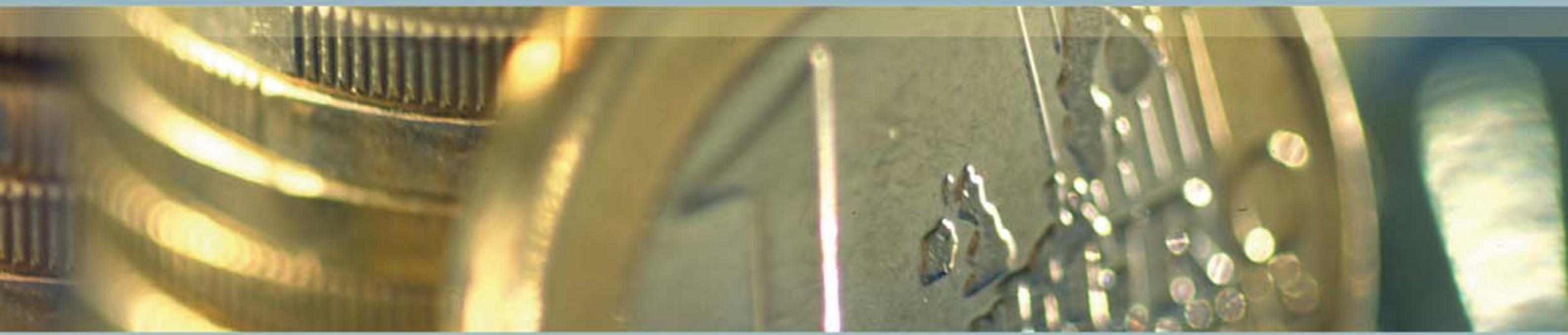

Progress towards meeting the economic criteria for accession: the assessments of the 2009 Progress Reports

Directorate-General for Economic and Financial Affairs

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European Commission
Directorate-General for Economic and Financial Affairs

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2009 Progress Reports on progress made towards meeting the accession criteria of each candidate[1] and potential candidate[2] country. The European Commission adopted these Reports on 14 October 2009. 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 2009 Progress Reports[3].

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 sub-criteria applied since 1997.

According to these the existence of a functioning market economy requires that:

- equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;

[1] Croatia, the former Yugoslav Republic of Macedonia and Turkey
[2] Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo (UN1244)
[3] Published by the European Commission's Directorate General for Enlargement
http://ec.europa.eu/enlargement/index_en.htm

- 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[4]. 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.

[4] For more short-term overview of recent economic developments, see for example the *"Candidate and Pre-Accession Countries' Economic Quarterly*": http://ec.europa.eu/economy_finance/db_indicators/db_indicators9243_en.htm

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 2009 Progress Report

1. CROATIA

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

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The country participates in the EU Pre-Accession Fiscal Surveillance procedure. The Pre-accession Economic Programme (PEP) 2009-2011, submitted in January 2009, presented a sufficiently comprehensive and consistent macroeconomic and fiscal framework for economic policies. The programme and its assumptions became however quickly outdated due to the impact of the international crisis. The fiscal notification submitted in April 2009 was an important step in further aligning fiscal reporting to ESA 95 standards, although weaknesses remain. Broad political consensus on the key essentials of a market economy has been maintained. Transparency on economic policy issues and in decision making was improved by the setting-up of an economic council comprising major stakeholders. However, economic policy making was often based on ad hoc decisions and economic reforms sometimes lacked a strategic medium-term orientation. *Overall*, consensus on the fundamentals of a market economy has been maintained, but Croatia lacks a medium-term and structural reform strategy.

Macroeconomic stability

The global financial and economic crisis started to affect the Croatian economy more severely in the last quarter of 2008, when GDP growth dropped markedly to 0.2% year-on-year. For the whole year of 2008, annual GDP growth slowed to 2.4%, down from 5.5% in 2007. In particular, private and public consumption growth slowed considerably in the course of 2008, while real investment growth accelerated (from 6.5% in 2007 to 8.2% in 2008), mainly on the back of strong activity in non-housing construction. The growth of exports declined to 1.7% (from 4.3% in 2007), while total imports decelerated to 3.6% (6.5%), and the contribution of net exports to growth remained negative. On the supply side, growth was mainly driven by the still robust performance of some services, including financial intermediation, construction and transport. Economic performance deteriorated significantly in the first half of 2009. Real GDP declined by 6.5% year-on-year, on the back of sharp drops in private consumption (-9.7% year-on-year) and investments (-12.6%). Industrial production declined by 9.1% year-on-year in July, indicating further drops in output in the third quarter. At the same time the tourism sector performed better than expected during summer, somewhat cushioning the recession. Average per-capita income in 2008 rose to 63% of the EU-27 average, from 61.1% a year before. *Overall*, the global crisis has led to a significant economic downturn.

In 2008, the current account deficit widened to 9.4% of GDP, up from 7.6% in 2007. This was partly driven by a deterioration of the trade balance. Higher oil prices and declining growth of exports to the main trading partners in the EU pushed the trade deficit up to 22.9% of GDP, from 22% a year before. As in previous years, roughly two thirds of the trade gap was covered by the surplus in services, mainly tourism and transport. The deficit of the income balance increased markedly, from 2.6% in 2007 to 3.3% in 2008, mainly reflecting higher debt servicing costs in an environment of tighter external financing constraints and lower foreign revenues. In the first seven months of 2009, the trade and current account deficits gradually declined, as merchandise imports dropped more strongly (-26.8% year-on-year) than exports (-20.7%). In the twelve months to June 2009, the current account deficit shrank to 6% of GDP. *Overall*, the current account deficit has been declining in line with slowing domestic demand.

Table 1.1:
Croatia - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	4.2	4.2	4.7	5.5	2.4	-6.5
Private consumption	Ann. % ch	4.3	4.4	3.5	6.2	0.8	-9.7
Gross fixed capital formation	Ann. % ch	5.0	4.9	10.9	6.5	8.2	-12.6
Unemployment	%	13.8	12.7	11.2	9.6	8.4	9.2
Employment	Ann. % ch	1.2	0.8	3.3	3.3	2.5	-1.5
Wages	Ann. % ch	6.4	4.4	6.2	6.2	7.1	4.0
Current account balance	% of GDP	-4.5	-5.6	-7.0	-7.6	-9.4	-7.0
Direct investment (FDI, net)	% of GDP	1.8	3.4	6.5	8.1	6.5	4.7
CPI	Ann. % ch	2.0	3.3	3.2	2.9	6.1	3.3
Interest rate (3 months)	% p.a.	7.32	6.21	4.46	5.66	7.19	10.00
Stock markets	Index	1,284	1,920	2,771	4,673	3,299	1,692
Exchange rate HRK/EUR	Value	7.50	7.39	7.30	7.33	7.22	7.38
Nominal eff. exchange rate	Index	91.7	90.4	89.3	87.3	84.3	88.4
General government balance	% of GDP	-4.6	-3.5	-3.1	-2.6	-1.4	-2.2
General government debt	% of GDP	37.9	38.3	35.7	33.1	33.5	n.a

Sources: Thomson Reuters/Ecowin

While net capital inflows remained relatively strong in the first three quarters of 2008, they came to a temporary halt during the last quarter. For the year as a whole, they reached 11.6% of GDP (somewhat higher than in 2007) and were again largely driven by foreign borrowing of banks and companies. In the context of tighter external financing conditions in late 2008, even some temporary capital outflows occurred, as private agents increased their foreign currency deposits abroad. Private banks started drawing down their external reserves to increase their foreign financing and to service outstanding external obligations. In the first half of 2009, total net capital inflows halved compared to the same period a year before.Net FDI remained an important source of foreign financing, although net inflows fell from 8.7% of GDP in the first half of 2008 to 3.9% of GDP in the first half of 2009. Net FDI covered around one third of the current account deficit, compared to 45% in the same period a year before. The structure of FDI continued to be dominated by equity investments, including moderate recapitalisations in the banking sector as well as the takeover of parts of the domestic oil company. *Overall*, despite slower net capital inflows due to the crisis, a sufficient amount of external financing could still be ensured.

The heavy external debt burden continued to increase, by €5.9 billion in 2008, and a further €1.6 billion in the first half of 2009. At end-2008, the stock of debt amounted to €39.1 billion, equivalent to around 82.6% of GDP, up from 77.6% at end-2007. The rise in external indebtedness was mainly due to intensive corporate sector borrowing which slowed however in late 2008 as a consequence of the crisis. Domestic banks managed to secure the roll-over of liabilities vis-à-vis parent banks in the last quarter of 2008, and increased their external debt in 2009. The relatively large exposure of the domestic non-tradable corporate sector, which accounts for around 40% of gross foreign debt, remains a cause for concern and warrants careful monitoring. A high external debt level, large exposure of the non-tradable sector and large debt obligations maturing over the short term continue to represent key external vulnerabilities of the Croatian economy.

According to data from the labour force survey, the unemployment rate further declined from 9.6% in 2007 to 8.4% in 2008. In the first quarter, it stood at 9.4%, compared to 10% a year ago. However, registered data confirm that the economic downturn has already taken its toll on the labour market. Total employment declined by 3.7% in the twelve months to July 2009. In the same period, the officially registered unemployment rate rose from 12.2% to 14%. Moreover, the Croatian labour market continues to suffer from structural problems, such as low participation and employment rates as well as high rates of youth and long-term unemployment. The effective retirement age remained low and significant labour supply disincentives persisted, such as generous early retirement rules and the predominance of categorical social welfare benefits. Stronger labour demand remained hampered by relatively rigid employment protection systems. As a result, labour turnover remained low, suggesting limited employment restructuring. The growth of average gross wages accelerated to 7.1% in 2008, up from 6.2% in 2007, and declined to 4% in the first half of 2009. Average real wage growth picked up somewhat recently, as inflation started to subside. *Overall*, labour market performance deteriorated as a result of the crisis and major structural weaknesses persist.

The monetary and foreign exchange system of a tightly managed float with a very limited degree of exchange rate flexibility remained in place as a main device to anchor inflation expectations. It has also helped mitigate potential exchange rate-induced credit risks in a highly euroised economy. Under conditions of a less benign external environment, tighter external financing constraints and higher lending spreads, the central bank released significant foreign exchange liquidity to the domestic banking system through a set of subsequent measures. This included the abolition of marginal reserve requirements on banks' foreign borrowing as well as a relaxation of reserve and liquidity requirements, effectively unfreezing banks' foreign currency holdings. Moreover, the central bank intervened twice in the foreign exchange market by selling euros for a total amount of around € 513 million([1]). As a result of monetary policy measures, official foreign reserves, which stood at € 9.3 billion at end-2007, started to drop in the second half of 2008. They temporarily fell to € 8.6 million in February 2009, and recovered to €9.1 billion by June, equivalent to around 5 months of imports. The average daily exchange rate fluctuated within a relatively small range between 7.11 and 7.49 kuna per euro and depreciated by 3.1% between October 2008 and mid-September 2009. *Overall*, monetary policy has managed to relieve external financing pressures by regulatory measures and thus contributed to preserving stability.

The current monetary framework required a relatively tight monetary stance, directed at limiting domestic kuna liquidity in line with available foreign exchange resources in order to ensure exchange rate and financial stability. Open market operations (repo auctions) were undertaken at a set rate of 6%, which effectively led to rationing, weaker market transparency and an increase in market rate volatility. Moreover, to allow for a more restrictive policy stance during periods of elevated depreciation pressures the authorities tightened collateral requirements. Domestic monetary and credit aggregates have been largely affected by the financial crisis, the economic slowdown and the monetary policy response. Annual growth of domestic credit to the private sector further decelerated from around 15% in 2007, but was still around 10% in 2008 and 4.3% in July 2009. In particular, the growth of lending to private households dropped more strongly than lending to the corporate sector. Domestic firms have increasingly shifted towards domestic sources of financing as a reaction to lower and more costly access to foreign capital. At the same time, the structure of outstanding credit has changed markedly due to a strong increase in government borrowing since December 2008. *Overall*, credit growth has fallen and the structure of credit has shifted towards government financing.

In 2008, average annual inflation increased significantly to 6.2%, up from 2.9% in 2007. This resulted from strong increases in oil and food prices in the first seven months and large carry-over effects from 2007. Following its peak in July 2008, annual inflation declined to 2.8% at end-2008 with lower energy and commodity prices and a slowdown in economic activity and private consumption growth. During the first quarter of 2009, inflation picked up temporarily to 3.8%, mainly resulting from adjustments in regulated gas prices, an increase in excise duties on tobacco and a seasonal increase in vegetable prices. In August, annual inflation came down to 1.4%. Core inflation decelerated to 4.1% at end-2008 and further to 3.4 % in mid-2009. *Overall*, as a result of falling world prices of commodities annual inflation has come down from its peak in 2008 with some temporary upward pressures in early 2009 mainly due to adjustments in regulated prices.

([1]) Following those two interventions, the central bank bought euros in a third intervention to mitigate appreciation pressures.

Public finances have come under increasing pressure since the fourth quarter of 2008, when revenues started to underperform in line with a deceleration of economic activity. The authorities reacted swiftly by adjusting current spending at short notice in the last months of 2008, and thereby managed to maintain the general government deficit for the year as a whole at 1.4% of GDP. However, revenue performance continued to weaken significantly in early 2009, forcing the government to increase domestic borrowing. The budget financing situation was temporarily alleviated by a successful € 750 million government eurobond issue in May. In the first half of 2009, state budget revenues declined by 8.6% year-on-year while expenditures increased by 7.9%. The central budget balance turned into a deficit, equivalent to 2.2% of projected GDP, compared to a surplus in the same period a year before. A bleaker economic outlook and worsening fiscal trends led the authorities to adopt a series of budget revisions. The first revision in April included a wage freeze for civil servants and public employees; it was however still based on optimistic growth assumptions. Considerable risks to the 2009 budget execution materialised quickly. A stronger-than-expected economic downturn and rapidly falling revenues forced the authorities to adopt a second, and shortly thereafter a third budget revision, in early and mid-July, respectively. The revisions included some cuts on spending and a number of measures to compensate for falling revenues, such as a special tax on income, a VAT increase of one percentage point, and increases in excises. Despite those adjustments, the revised planned general government deficit increased to 3.3% of GDP, thus pushing up financing requirements of the government sector and related financing risks. Moreover, risks of further declining revenues and higher spending aiming at combating the current crisis remained high. The stock of general government debt stood at 33.5% of GDP at end-2008, only slightly higher than a year before (33.1% of GDP), but it went up considerably in the first half of 2009. 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*, in reaction to mounting fiscal pressures, efforts were made to re-balance the budget. However, the policy response came late, revealing weaknesses in budget planning, and the fiscal deficit increased significantly.

The rationalisation of public spending has made limited progress. This is a key Accession Partnership priority. Some health reform measures were enacted as an important step towards addressing the sector's financial difficulties, including a more effective system of co-payments. No further reforms have been undertaken to achieve better targeting of social support, as envisaged under the social benefits reform strategy adopted back in 2007. Categorical benefits still account for the large majority of social spending. There has been no progress on reforming the mandatory pension system. *Overall*, apart from important initial health care financing reforms, little progress has been achieved in terms of increasing the efficiency of public spending.

The implementation of a comprehensive treasury reform strategy has continued with a view to further improving expenditure management and budget control systems. A new Budget Act came into effect, improving the legal basis for strategic and multi-annual budget planning. Continued progress was achieved in enhancing institutional and analytical capacity for setting up medium-term macroeconomic and fiscal frameworks. However, further progress in streamlining procedures would be needed to more effectively link defined policy priorities to the budget planning process. Further substantial efforts were undertaken to bring budget reporting more in line with ESA 95 standards. Fiscal transparency remains a concern, also due to the non-inclusion in the general government accounts of some quasi-fiscal operations (State Development Bank, Motorway Company) and a large number of municipalities. *Overall*, analytical and institutional capacity in public finance has improved, but strategy-based budget planning needs to be further strengthened.

Overall, the macroeconomic policy response has by and large been appropriate to address the spill-overs from the global economic and financial crisis. Within its given limits that ensue from the high degree of euroisation, monetary policy contributed successfully to preserving financial stability mainly through regulatory changes alleviating foreign exchange liquidity pressures. In reaction to mounting fiscal pressures, efforts were made to re-balance the budget. However, the gradual deterioration of the fiscal balance in combination with tight financing would have required a somewhat more timely and comprehensive fiscal response. The design of a credible fiscal strategy aimed at reducing budget rigidities and enhancing the efficiency of public spending remains a key challenge.

Interplay of market forces

The privatisation process progressed slowly. The only major transaction was the sale of additional assets of the national oil company to a foreign investor. The privatisation of assets held under the State Privatisation Fund made only limited progress. Up until June 2009, the State Privatisation Fund had sold or liquidated shares in some 103 companies, mainly consisting of minority shares. A total number of 29 tenders were published for the privatisation of companies in majority state ownership, but only 4 companies were actually sold. A number of issued tenders have not been successful, partly due to a lack of interest among potential investors and, in some cases, rather unrealistic sale conditions. The remaining portfolio of the Privatisation Fund still comprised 835 companies, with the State keeping a majority holding in 85 of them. Thus, the portfolio of the Fund has virtually remained unchanged. No progress has been achieved with the implementation of a new privatisation model under which state assets would be transferred to investment funds. The private sector's share in employment has remained at around 70%; the private sector share of GDP is estimated at around 70-80%. *Overall*, very limited progress has been achieved in reducing the role of the State in the real sector of the economy.

Market entry and exit

Company registration procedures have been further simplified, also by the introduction of on-line registration for limited liability companies. Preliminary data indicate that the number of newly registered companies declined by 27%([1]) and the stock of active businesses increased by 5.4% year-on-year in June, compared to a growth rate of 8% a year before. The government's project to reduce the regulatory burden by streamlining legislation and eliminating unnecessary regulations ('regulatory guillotine') started off well in 2007, but its implementation slowed. The investment climate remains hampered by difficulties in obtaining necessary licences, building permits and other authorisations. A large number of para-fiscal taxes at the national and local level do seem to add significantly to the tax burden of entrepreneurs. The business environment is also affected by petty corruption and an inefficient public administration. *Overall*, further progress has been made in simplifying company registration, but the investment climate continued to suffer from a heavy regulatory burden and numerous para-fiscal taxes. Improving the business environment is a key Accession Partnership priority.

Legal system

Further progress was made in reducing the backlog of cases before Croatian courts. During 2008, the backlog was reduced by 8.4% compared to 2007. However, there is still a large backlog (887,000 cases at end-2008). The length of proceedings before the courts remains generally excessive and major problems continue to exist with the enforcement of court decisions. The weaknesses of the judicial system continue to undermine effective enforcement of creditor and property rights. Land registration has improved, but remains incomplete in parts of the country. Investors still suffer from lengthy procedures to register a property. *Overall*, improvements to the judicial system have been made, but major inefficiencies in the judiciary remain.

([1]) Last quarter 2008 and first half of 2009 compared to the same period a year earlier.

Financial sector development

The financial sector remained dominated by banks, representing around 77% of total assets of financial intermediaries in mid-2009. The banking sector is almost completely privatised with a 90% share of foreign ownership in terms of net assets. Out of 33 banks, two banks remained state-owned. The degree of market concentration has remained at a moderate level and has generally not been an impediment to market competition. The four largest banks together kept a market share of around 65% by mid-2009. Banking sector assets continued to grow, but at a slower pace, and the structure of assets changed considerably. This is due to a reduction of banks' foreign assets and reserves with the central bank, resulting from regulatory changes. Total credit growth slowed, reflecting lower demand and higher risk awareness of banks in the context of the global financial crisis, but lending to the government sector increased strongly. In terms of GDP, total bank lending continued to rise, from 68.8% in 2007 to 72% of GDP in 2008, and further to 74.6% in mid-2009. *Overall*, the largely private and foreign-owned banking sector remained the key financial sector player with a moderate degree of market concentration.

As a result of a number of prudential and supervisory measures that had been taken earlier to address potential macro-financial vulnerabilities, the banking sector remained well capitalised, and profitability indicators stayed at rather comfortable levels in 2008, before they slightly worsened in the first half of 2009. The share of non-performing loans increased from 4.9% at end-2008 to 6.1% in June 2009 under a less favourable economic environment. Moreover, the banking system remained confronted with considerable interest- and currency-induced credit risks, as the majority of loans are based on variable interest rates and denominated in or indexed to foreign exchange. Financial sector stability developments have been kept under close watch by the central bank, which further enhanced its institutional and analytical capacity to produce forward-looking financial sector stability assessments of high quality. *Overall*, the banking sector remained resilient to shocks, but significant risks are related to largely un-hedged balances of the non-financial private sector.

The share of non-banking financial sector assets in total financial sector assets declined from 26% at end-2007 to 23% in mid-2009, largely due to poor performance of investment funds, which experienced significant share price declines and money withdrawals in the context of the global financial crisis. At the same time, leasing companies and the insurance sector gained in absolute and relative terms. The domestic stock and bond markets also suffered from the deepening international crisis. The stock market index lost almost 70% in 2008, and market capitalisation of shares listed on the Zagreb stock exchange fell from 128% to 42% of GDP. Stock markets started to recover somewhat in March 2009, and the index gained some 15% in the fist half of the year. In 2008, bond markets registered the lowest turnover since 2003, and market capitalisation of all listed bonds declined from 15% to 10% of GDP, resulting from falling bond prices, maturing bonds and limited new bond issues. *Overall*, notwithstanding the growth of some market segments, financial intermediation by the non-banking sector remained shallow and stock and bond markets experienced significant losses following the outbreak of the crisis.

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

Existence of a functioning market economy

The policy response to the global financial crisis has by and large been conducive to preserving macro-financial stability, although fiscal risks remain significant. A prudent response by monetary authorities as well as efforts to re-balance the budget helped anchor expectations of economic agents and supported the functioning of market mechanisms. However, the slow pace of economic restructuring and 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 over the medium term.

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, including through the provision of educational programmes for teachers. Additional efforts have been made in the development of a national qualifications framework. Higher education has been further aligned with the principles of the Bologna process, but the tertiary education sector suffers from inefficiencies, poor governance and a lack of funding.

The government continued to implement labour market policies on the basis of the National Employment Promotion Plan. Measures include training and employment subsidies for young people without work experience, the long-term unemployed, older persons and vulnerable groups. A new Law on the Restructuring of Unemployment Benefits was adopted. It leads to higher replacement rates in the first three months followed by a gradual decrease thereafter, and offers financial incentives for the unemployed to participate in educational measures. Wage subsidies were introduced in the context of the introduction of a 32 hour working week. Structural problems persisted as the rate of youth and long-term unemployment remained high at 22% and 5.3%, respectively. Moreover, a slowing economy has led to a drop in employment and participation rates. From an already low level, they dropped slightly to 56.5% and 62.6%, respectively, in the first quarter. *Overall*, low employment rates and structural mismatches between labour supply and demand remain important challenges.

Further progress has been made in developing a knowledge-based economy. The ICT infrastructure is rather well developed, with high internet and broadband penetration rates. The share of the business sector in total spending on research and development has increased. Investment continued to be relatively robust in 2008, mainly due to construction activities, keeping the investment ratio at around 28% of GDP. Private investment accounted for the bulk of it (22% of GDP). However, private investments in the processing and manufacturing industry have remained low, constraining prospects for faster technological change, a more diversified production structure and higher export potential. Public investment remained also relatively strong. In particular, investments in new highways resulted in a further expansion of the network. FDI continued to play a significant role. The total stock of FDI reached € 21.4 billion (44% of GDP). The largest share of cumulative FDI inflows is accounted for by the financial sector (38%), followed by manufacturing (23%) and wholesale and retail trade (15%). However, there has still been little greenfield investment. *Overall,* investment continued to be concentrated in transport infrastructure and the services sector.

Sectoral and enterprise structure

The government decided to restructure the loss-making shipyards through a process of privatisation and started the necessary preparations. This is a key Accession Partnership priority. An agreement was reached with the Commission on the arrangements for the privatisation, enabling international tenders to be launched for the six yards in difficulty. The implementation of the National Restructuring Programme (NRP) for the steel sector has been disrupted by the global economic crisis. Therefore, the NRP as well as individual business plans will have to be revised. The restructuring of the large loss-making railway carrier and the privatisation of subsidiaries has made very limited progress. The objectives of the business plan for 2008 were not fully met, despite some correction of earlier wage increases. The envisaged reduction of the working ratio in 2008 did not materialise and the railway sector continued to receive high levels of budget support. *Overall*, good progress has been made in particular as regards the tendering of the yards with a view to their restructuring through privatisation. However, sustained efforts are required to complete the restructuring of the steel and railway sectors to ensure their long-term viability and competitiveness.

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. Fixed line competitors raised their market share further from 19% to a still modest 24%. Liberalisation of the energy sector continued gradually and network rules for the transport and distribution of gas have been enacted. However, gas and electricity markets remain dominated by single suppliers, undermining effective competition. The restructuring of the large electricity company has not advanced. *Overall*, despite further legal and regulatory adjustments, competition in network industries remains constrained by dominant incumbent suppliers.

The already large service sector maintained its share in total output at around 65% in 2008. The share of construction increased, from 7.7% to 8.3% of total output, as a result of buoyant activity, while the share of industry declined. The share of the industrial sector and of construction in total employment remained unchanged at around 19% and 9% respectively. Agriculture's share of employment increased from 12.8% to 13.2%, and that of the services sector dropped accordingly. The already large service sector accounts for two thirds of the economy and the share of construction in total output increased.

In 2008, the SME sector represented around 40% of the corporate sector's total assets, 66.2% of total employment and 65% of total investment. SMEs generated 44% of GDP and more than 40% of total exports. Those indicators remained virtually unchanged compared to the previous year. In order to support the small and medium-sized enterprise (SME) sector the government adopted a new operational plan for 2009. The State Development Bank (HBOR) has been financially strengthened, also through EIB loans, to increase lending to the SME sector on favourable terms. On the other hand, 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. Commercial lending to the SME sector is further restricted by the presence of several subsidised government programmes. *Overall*, while the SME sector continued to benefit from large-scale government support, its share in the overall economy has not increased.

State influence on competitiveness

The government adopted a set of ten anti-recession measures, including reduction of the cost burden, financial strengthening of the State Development Bank (HBOR), and support for tourism, SMEs and the real estate market. The implementation of the anti-crisis programme has been slow and its impact on competitiveness remains uncertain, in particular as regards subsidies for real estate loans, liquidity injections into public companies and import controls. There has been a lack of progress in reducing the large number of levies and fees, mostly at local level, which put a significant financial burden on the business sector. The role of the Competition Agency in monitoring and controlling state aid has been further strengthened, but administrative capacity and enforcement of competition policy needs to be enhanced. The total amount of subsidies in the 2008 and 2009 general government budgets remained high — at around 2.4% of GDP — and a large share has still been provided to loss-making companies. Although horizontal aid has increased relative to sector aid, it still accounts for only a small share of total subsidies. *Overall*, state intervention in the enterprise sector remained substantial and has been further increased by the set of anti-recession measures.

Economic integration with the EU

Croatia is an open economy with total trade in goods and services representing around 92% of GDP. Apart from the export of machinery and transport equipment (mainly ships), tourism continued to be the biggest source of export revenue, representing almost 20% of GDP in 2008. The EU has continued to be the largest trading partner. Its share in total Croatian exports and imports remained at around 61% and 64% respectively. However, in the first six months of 2009, the share of the EU in Croatian imports and exports decreased slightly, as trade with developing countries dropped more slowly than trade with the EU. CEFTA countries represented 10.9% of all Croatian trade in 2008. In the first six month of 2009, the share slightly decreased to 9.9%. In this period, CEFTA countries made 4.8% of total imports into Croatia and 20.1% of all Croatian exports. Around 93% of FDI inflows originate from EU Member States. *Overall*, integration with the EU in the areas of trade and investment remained high.

The average growth in real wages decelerated significantly to 1% in 2008, due to an increase in average inflation. However, wages have increased more strongly than estimated average labour productivity, with the result that unit labour costs have slightly gone up. Indicators of export price competitiveness have slightly improved as the kuna weakened somewhat vis-à-vis the euro and the US dollar. In the nine months to June 2009, the exchange rate of the kuna depreciated by 3.2% against a basket of currencies in nominal terms. In real effective terms, corrected for consumer price developments, the kuna weakened by a lower rate of 0.6%, as a result of relatively higher inflation in Croatia. *Overall*, standard indicators do not point to significant changes in export price competitiveness.

1.3. CONCLUSION

The economy of Croatia has been increasingly hit by the global crisis. The country entered into recession in the first half of 2009 and unemployment increased. Macro-economic stability has been preserved by a prudent monetary policy. Some efforts to rebalance the budget were made, but the fiscal deficit increased significantly. The banking sector remained sound and resilient to the crisis. A high level of external indebtedness and large short-term repayment obligations are key vulnerabilities of the economy. The process of economic restructuring and privatisation has remained slow and limited improvements in the business environment have been made.

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, provided that it further implements its comprehensive reform programme with determination in order to reduce structural weaknesses.

The macroeconomic policy response has by and large been appropriate to address spill-overs from the crisis. In particular, monetary policy contributed successfully to preserving financial stability mainly by alleviating foreign exchange liquidity constraints through regulatory changes. In reaction to mounting fiscal pressures, some adjustments in spending as well as measures to compensate for falling revenues were adopted in the context of successive budget revisions. The legal basis for strategic and multiannual budget planning and reporting was improved. A health reform was adopted to improve the financial situation of the health sector. External imbalances have narrowed, exchange rate stability has been preserved, and inflationary pressures have subsided. The banking sector remained resilient to shocks and credit growth has declined. Croatia's economy is well integrated with the EU.

However, the government's economic policy has sometimes lacked a clear medium-term orientation. Policy coordination within the government and between the government and the central bank is sometimes weak. Structural reforms have generally advanced at a slow pace, in particular with respect to the restructuring of loss-making enterprises. The labour market suffers from low employment and participation rates, which have worsened with the crisis. Only limited progress has been achieved with reforms aimed at addressing labour market rigidities. In the context of the crisis, significant risks of higher spending and further declines in revenues have materialised. The fiscal deficit increased significantly. The late policy response revealed weaknesses in the budget planning process. Moreover, little progress has been achieved in increasing the efficiency of public spending. Social transfers remained high and not well-targeted and a large number of public and state-owned enterprises continued to receive state support through subsidies and guarantees. Therefore, the design of a credible fiscal strategy aimed at reducing budget rigidities and enhancing the efficiency of public spending remains a key challenge. Further progress has been made in facilitating business registration procedures, but the investment climate continued to suffer form a heavy regulatory burden and numerous para-fiscal taxes.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

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

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The country is participating in the EU pre-accession fiscal surveillance procedure. It presented its third Pre-accession Economic Programme in January 2009 and submitted its fourth fiscal notification in April 2009. However, the programme and its assumptions quickly became outdated, as a result of the rapidly changing international environment. Another corner-stone of the country's economic policy framework has been cooperation with the World Bank. Furthermore, a number of medium-term strategies define the policy framework, such as the national development plan, the public investment programme for 2009-2011 and the public debt strategy for 2009-2011. Although the government was geared strongly to the local and presidential elections, structural reforms continued in a number of areas. *Overall*, a broad political consensus on the fundamentals of economic policy has been maintained.

Macroeconomic stability

GDP growth decelerated from 5.9% in 2007 to 5% in 2008. However, after strong growth in the first three quarters of 2008 of nearly 6% on average, output growth dropped to 2% in the fourth quarter, reflecting the negative impact of the global financial crisis. Economic activity continued to slow down in the first half of 2009, with a year-on-year output drop by 1% and 1.5% in the first and second quarters. Production and employment in key export-oriented industries, such as steel and textiles, have started to decline. Exports declined markedly in late 2008 and early 2009, while investment and imports began to decline substantially in the second quarter only. Industrial production declined by an average of around 11% during the first half of 2009, mainly as a result of lower output of basic metals. Average per-capita income (in PPS) has increased, from 31.2% of the EU-27 average in 2007 to 32.5% in 2008. Overall, after strong growth in the first three quarters of 2008, economic activity slightly contracted in the first half of 2009, mainly reflecting lower external demand. However, so far the slowdown has been limited.

The current account deficit declined from some 16% of GDP in the first of half of 2008 to about 14% in the first half of 2009. The main reason was a significant decline in imports, in particular in mid-2009, while the drop in exports remained limited. However, falling private transfers from abroad prevented a stronger decline in external imbalances. At the same time, capital inflows, such as FDI declined. Overall, external imbalances remained elevated, as strong public spending during the first months of the year kept imports high, while capital inflows were affected by the global crisis. This contributed to pressure on the country's foreign exchange reserves.

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

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	4.1	4.1	4.0	5.9	5.0	-1.2
Private consumption	Ann. % ch	6.2	5.7	6.0	9.8	7.8	n.a
Gross fixed capital formation	Ann. % ch	10.9	-5.4	11.6	13.3	16.5	n.a
Unemployment	%	37.2	37.3	36.0	34.9	33.8	32.7*
Employment	Ann. % ch	-4.1	4.3	4.6	3.5	3.2	2.9*
Wages	Ann. % ch	4.0	2.7	8.0	4.8	8.0	17.7
Current account balance	% of GDP	-8.4	-2.6	0.9	-7.2	-13.1	-14.6
Direct investment (FDI, net)	% of GDP	6.0	1.6	6.8	4.1	6.5	4.6
CPI	Ann. % ch	-0.4	0.5	3.2	2.3	8.3	0.1
Interest rate (3 months)	% p.a.	8.49	9.95	6.40	5.60	6.69	8.55
Stock markets	Index	911	1,930	3,219	6,971	5,149	2,089
Exchange rate MKD/EUR	Value	61.32	61.30	61.19	61.18	61.26	61.38
Nominal eff. exchange rate	Index	104.4	104.7	104.9	104.5	105.6	111.8*
General government balance	% of GDP	0.0	0.2	-0.5	0.6	-0.9	n.a
General government debt	% of GDP	43.8	39.6	31.4	23.4	21.4	n.a

Sources: Thomson Reuters/Ecowin * Q1

The official reserve assets of the *National Bank of the Republic of Macedonia* (NBRM) dropped sharply in early 2009 but recovered by July to about €1,4 bn (20% of GDP). This is some 20% below their peak in September 2008. The import coverage has dropped to around five months of imports. Major factors driving this decline were dividend payments, government purchases of equipment, foreign exchange withdrawals by private households in spring 2009, reflecting increased uncertainty, and Central Bank intervention to defend the *de facto* peg to the euro. Gross external debt has continued to rise (from 51% of GDP in September 2008 to 53% in June 2009), mainly reflecting increased borrowing abroad by private companies. In July, the authorities issued an €175 million eurobond (2.5% of GDP), in order to strengthen foreign exchange reserves and to cover public sector financing needs. External vulnerability has increased, as exports and capital inflows dropped while substantial public spending boosted imports. Public borrowing on the domestic financial market has contributed to a rise in lending rates, while private and public borrowing on foreign capital markets has increased the country's external indebtedness. Overall, the crisis and increased public spending had a negative impact on level of foreign exchange reserves and external debt.

Unemployment remained very high. It dropped slightly from 34.9% on average in 2007 to 33.7% in 2008. The Labour Force Survey (LFS) and national statistics point to a slight decline in unemployment when compared to a year before. For example, unemployment rates dropped from 34.8% in the first quarter of 2008 to 32.8% in the first quarter of 2009, while until May 2009, the number of registered and actively labour seeking unemployed is below the previous year levels. However, data from June and July indicate a increase in unemployment, probably related to the crisis. Recent government measures to fight unemployment have focused on youth unemployment and may have contributed to the slight drop in the unemployment rate. In the age group of 15-27 years, unemployment has declined a bit faster than in other age groups, from 58.4% in the first quarter of 2008 to 54.4% in the first quarter of 2009. The existence of a substantial informal sector still seems to lead to significant over-estimation of actual unemployment. However, even when taking this factor into account, very high unemployment remains an important issue, in particular among young people and the less educated. Overall, the trend towards a slightly improving labour market situation, notably among youth, seems to have continued. However, the level of unemployment of some 33% remains very high.

Monetary and exchange rate policy have remained stability-oriented. The Central Bank has managed to maintain the *de facto* peg, keeping the exchange rate stable at 61.2 denar to the euro. In April the

Central Bank raised interest rates for short-term Central Bank bills from 7% to 9%, largely to neutralise the impact of the government's expansive fiscal policy. Private-sector weighted interest rates started to rise in spring 2009. Rates for denar loans increased from 9.6% in August 2008 to 10.2% in July 2009, while the rates for denar deposits rose in the same period from 6.0% to 7.2%. Spreads have continued to narrow, from 3.6% in August 2008 to 3.0% in July. The originally high growth in credit to the private sector decelerated from 38.4% in September 2008 to 14.2% in July 2009, reflecting lower growth in deposits but also Central Bank measures to tighten credit expansion. Overall, the exchange rate and monetary policy have remained sound, notably by maintaining the level of the de facto peg to the euro, which has helped to maintain confidence in the stability of the financial system.

Inflation reached 8.3% in 2008 compared with 2.3% in 2007. However in the first eight months of 2009, the average price level was 0.3% below the level a year before, mainly due to lower prices for food and transport. This profile is in line with the decelerating economic activity. Overall, inflation has decelerated markedly.

The fiscal policy stance has become more expansionary, envisaging a further increase in the deficit from an actual deficit of 0.9% of GDP in 2008 to a target of 2.8% in 2009. In the last quarter of 2008, the government embarked on a large spending programme, which turned the previously accumulated surplus of some 2% of GDP into a year-end deficit of close to 1%. The main spending measures at the end of 2008 were income transfers to farmers, subsidies to the State-owned electricity companies and additional budgetary allocations to other policy areas. Between December 2008 and May 2009, the government announced three crisis-related packages. The first consisted mainly of a payment amnesty of accrued tax arrears and the transformation of tax arrears of three former State-owned enterprises into State shares. In addition, reinvested earnings were exempted from profit taxation, which lowered tax revenues by some 1% to 2% of GDP. Furthermore, deadlines for tax collection were eased. In March the authorities announced their annual update of their five-year investment programme, planning to raise public investment from some 3% of GDP to about 7%. In May and August the authorities responded to lower than expected revenue by submitting to parliament two rebalancing budget proposals, cutting public spending in total by some 12% compared with the initial budget proposal. However, compared with the actual spending in 2008, the revised budget still envisages substantial spending increases. The impact of automatic stabilisers is likely to be very limited. General government debt declined from 26% of GDP in 2007 to 21% in 2008. The main factors behind this decline were strong nominal GDP growth and a low fiscal deficit. However, as a result of deficit financing, public debt increased to about 25% of GDP by mid-2009([1]). Overall, increased public spending coupled with a crisis related decline in revenues led to a significantly higher public sector financing gap and increased public debt.

In the area of fiscal reforms, the government proceeded with lowering the tax wedge on labour by reducing social contributions and simplifying collection. Furthermore, the authorities have continued to improve the efficiency of tax administration and to simplify the tax system. Fiscal decentralisation has continued. The legal framework for local cooperation and also for auditing has been strengthened. However, the central government's administrative capacity for monitoring and auditing fiscal decentralisation remains limited. The new responsibilities continue to pose significant challenges to the municipalities and require close monitoring by the central authorities. Overall, the quality of public finances continues to be hampered by weaknesses in medium-term budget planning and priority-setting, leading to a high proportion of discretionary and short-term spending decisions.

The overall macroeconomic policy mix suffered from the low quality of government spending, with many measures geared more to election-related promises than to combating the crisis. Some spending contributed to an increase in the trade deficit. As a result, the country's external vulnerability

([1]) Public-sector data are not yet presented in accordance with the European standard (ESA 95), thus limiting comparability.

increased and the *de facto* peg of the denar to the euro – which is the core monetary policy anchor - came under pressure. Inflation decelerated, reflecting declining international energy and commodity prices. Additional measures to address structural unemployment, which is a key Accession Partnership priority, seem to have produced some initial positive results. However, the very high level of unemployment remains a key challenge. *Overall*, the expansionary fiscal policy was poorly targeted and contributed to the pressure on external balances and the foreign exchange anchor. However, macroeconomic stability was maintained.

Interplay of market forces

Privatisation is largely completed and the economy is mainly driven by market forces. The private sector accounts for some 82% of total output generation and some 77% of total employment. However, during the last year some of the anti-crisis measures led to an increase in the State's involvement. For example, the measure to offer debt-equity swaps to troubled companies with substantial payment arrears increased the number of companies under State ownership from 58 to 70 (15%), leading to a rise in the share of State capital from 11% of GDP in mid-2008 to 13% in mid-2009.

More than 90% of the State capital is concentrated in five companies, mainly public utilities, such as for electricity production and transmission. The persisting practice of setting electricity prices below cost recovery is a significant burden on public spending and distorts the domestic price structure. *Overall*, the State's role in the economy has increased slightly as a result of some of the anti-crisis measures. However, market forces are still the predominant feature of the economy.

Market entry and exit

The government has continued improving legislation on market entry and exit. The second phase of establishing a 'one-stop shop' for business start-ups has been launched, focusing on facilitating the exchange of information between the various data-collecting institutions, such as the central registry, the Employment Agency and the health insurance funds. Updating the legal framework for electronic registration and reporting has been another important step. The costs of registration have been reduced further. The second phase of the 'regulatory guillotine' to reduce unnecessary administrative burdens has been completed, adopting measures to accelerate and simplify customs procedures. With regard to closing enterprises, voluntary liquidation has been introduced and the backlog of overdue cases has been reduced further. However, the number of newly created enterprises dropped by some 20% in the first eight months of 2009, compared with the same period the year before. The number of enterprises exiting the market has increased. This reflects to a large extent impact of the international financial crisis. However, the number of new bankruptcies was lower in the first eight months than a year before. The average duration of bankruptcy procedures has fallen slightly, from two years and two months to around two years. The backlog in bankruptcy cases has been further reduced. *Overall*, further progress has been made on reducing barriers to market entry and exit.

Legal system

Some further measures have been taken to improve the business environment, which is a key Accession Partnership priority. The legal system for a functioning market economy is largely in place. Good progress has continued to be made with registration of property rights, by further extending the coverage of the real estate cadastre to more than 90% of the country's territory compared with 82% in September 2008. The backlog of unresolved property disputes has been reduced further, from some 7,500 in autumn 2008 to some 2,400 by September 2009. However, in general, legal procedures are still slow and sometimes the quality of court decisions is low. This is continuing to have a negative impact on legal certainty and is impeding the proper functioning of market mechanisms, with an adverse impact on the business environment and the country's attractiveness to foreign investment.

The financial independence and administrative capacity of regulatory bodies were strengthened. However, some regulatory and supervisory agencies are not yet fulfilling their role as guardians of the rule of law and providers of a level playing field for all economic operators. 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. *Overall*, clarification of property rights has further advanced. However, weaknesses in the judiciary, including slow procedures and insufficient resources, are continuing to have an adverse impact on the business environment, for example in the area of contract enforcement. Corruption has been addressed by policy measures, but remains prevalent in many areas.

Financial sector development

The financial sector remained stable and so far has withstood well the turbulence on international financial markets. Deposits are the sector's main source of liquidity. The value of its financial assets declined slightly, from 65% of GDP in September 2008 to 63% in mid-2009. The volume of credits rose slightly, from 41% of GDP in September 2008 to about 42% in mid-2009. Deposits have declined as a share of GDP, from 45% in September 2008 to 41% in mid-2009. As a result, the coverage of credits by deposits has declined, but is still slightly above 100%. Two voluntary pension insurance funds started operation in 2009, but overall, financial intermediation by the non-banking sector has remained very low. After a strong decline in 2008, the capitalisation of bond and stock markets has recovered slightly in recent months, reaching some 29% of GDP (stocks 25% and bonds 4%), which is the level recorded at the end of 2006.

The structure of the sector has remained largely unchanged. However, the share of foreign capital in it has increased, due to foreign investments in three domestic banks. The share of State ownership in the sector remains low, at some 6.5% 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.

There are 18 banks and 11 savings banks operating in the market, 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 the continued narrowing of spreads between lending and borrowing rates, from 3.5 percentage points in September 2008 to 3.2 percentage points in April 2009. Following the outbreak of the crisis, profitability in the sector dropped sharply, with the average return on equity declining from 16.5% in September 2008 to 1.8% in March 2009. The return on assets declined from 1.9% in September 2008 to 0.2% in March 2009. In order to contain the originally rapid expansion of credit and to lower the pressure on foreign exchange reserves, the Central Bank introduced a number of administrative measures.

Despite increased uncertainty, the stability of the sector has been maintained, benefiting from the stricter regulatory standards and stronger supervisory capacity introduced in the last few years. The exposure of the banking sector to non-performing loans rose slightly in the first half of 2009. Their share in total loans rose to 7.5% at the end of March 2009, compared with 6.6% in September 2008, thus returning to the level recorded in 2006. Loans with a foreign currency component remained largely stable at some 54% of total loans. The capitalisation of the banking sector remained high, with an average capital adequacy ratio of 17% in the first quarter of 2009. Large banks reported an average capital adequacy ratio of 14% and small banks as high as 60%. *Overall*, the financial sector maintained a sound performance, weathering relatively well the negative impact of the global financial crisis. The size of the sector remained stable, with total assets accounting for some 60% of GDP.

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

Existence of a functioning market economy

Overall, macroeconomic stability has been maintained despite the negative impact of the global financial turbulence. Further progress has been made on improving conditions for market entry and exit, registration of property rights and addressing impediments to job creation. However, the slow pace of judiciary procedures and the at times deficiencies of supervisory and regulatory agencies are still hampering the functioning of the market economy, in particular with respect to contract enforcement and establishment of a level playing field for market participants. Structural unemployment remains very high, pointing to structural weaknesses, such as skills mismatches, and insufficient functioning of the labour market.

Human and physical capital

The authorities maintained their efforts to provide education to a greater number of pupils and to improve vocational training for adults. Budgetary allocations for education increased, from around 3% of GDP in 2007 to about 4% in 2008. A significant share of the additional spending has been on renovation and construction of school buildings and the purchase of IT equipment. The number of teachers in primary and secondary schools has been increased by some 4%, in particular in the area of primary education. However, there is still room for improvement in the efficiency of public spending on education and the quality of education. Despite these efforts, the overall level of education and training of the labour force is still relatively low and the mismatch between the qualification profile of the labour force and the requirements of enterprises still seems substantial. *Overall*, measures to improve the level of qualification have continued. However, further sustained efforts are necessary**.**

The country's capital endowment has remained relatively low and its quality is still suffering from previous periods of under-investment. Some further progress has been made on improving the electricity network and upgrading further parts of European North-South transport corridor - Corridor X. Largely as a consequence of the crisis, inflows of FDI have decelerated after relatively strong growth in recent years, falling to some 5% of GDP in the first quarter of 2009, compared with about 12% the year before. In some cases, persistently slow legal procedures and fragmentation of responsibilities between central and local governments are an impediment to FDI. *Overall*, the country's capital stock remains relatively low, in particular in the light of the need to accelerate growth. Infrastructure continues to require repair and modernisation.

Sectoral and enterprise structure

In terms of output generation, the overall trend towards a larger contribution by manufacturing, construction and trade in services and a declining share of agriculture has continued. In terms of employment, services and agriculture grew in importance, while in terms of enterprise creation the trading sector appears to be the most dynamic. To a certain extent, this increase in trading companies might reflect a relative reduction in unregistered economic activities more than a structural change. However, this overall picture could also point to a trend of increasing employment in activities with low capital and skill requirements but also low value added and, thus, also low income. The informal sector remains large, although there are indications that it has been reduced somewhat, for example by improving tax collection, lowering the tax burden, reforming collection of social security contributions and providing financial incentives for registration. Liberalisation of the telecommunication industry continued. However, gas and electricity markets remain dominated by single suppliers, undermining effective competition. *Overall*, limited progress has been made on structural change towards diversification and activities with higher value-added. Competition in network industries remains constrained by dominant incumbent suppliers

State influence on competitiveness

Direct State influence on competitiveness is low but has increased, partly as a result of government intervention to shield troubled companies from the negative impact of the crisis. Indirect State aid is still leading to distortion in relative prices, in particular in the electricity sector. Energy prices still do not cover the full costs, which distorts the price structure, leads to substantial losses on the part of State-owned energy providers and requires significant budgetary transfers. Official data on State aid point to a low level of about 1% of GDP. However, this figure is not comparable to State aid data compiled in accordance with EU standards. *Overall*, State influence on competition is low in most areas.

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 in 2008. Trade integration with the EU is advanced, with about 60% of all exports being directed to and about 50% of imports originating from EU-27. CEFTA is the country's second most important trading partner, with about 37% of exports and about 11% of imports. The importance of CEFTA as an export destination has continued to increase. The export structure remains highly concentrated on a limited range of products, with textiles and clothing accounting for about 24% of total exports and manufactured iron products for some 26%. *Overall*, trade integration with the EU is well advanced, but the commodity mix remains concentrated on a few price-sensitive products.

International price competitiveness remained unchanged. The exchange rate against the euro has remained stable in nominal terms, while *de facto* wage increases took into account international price developments.

2.3. CONCLUSION

The economy of the former Yugoslav Republic of Macedonia slowed down and slightly contracted in 2009, as the international environment deteriorated. Inflation declined markedly, mainly due to lower international energy and commodity prices. Some progress has been achieved in addressing structural unemployment and in reducing impediments to employment. However, the still very high unemployment, in particular among young and poorly educated, remains a major cause of concern. Weaknesses in the administration and the rule of law continue to have a negative bearing on the business climate.

As regards the economic criteria, the former Yugoslav Republic of Macedonia is well advanced. It has continued to move 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 reform programme in order to reduce significant structural weaknesses.

The country has maintained a broad consensus on the essentials of economic policies. Privatisation is largely completed. Price and trade liberalisation has been largely accomplished. Market entry and registration has been further improved and the regulatory framework has been further simplified. Bankruptcy procedures have been further shortened and property registration is well advanced. The authorities have increased their efforts in addressing structural unemployment and measures have been taken to reduce the tax burden on labour. Financial independence of supervisory and regulatory agencies has been strengthened. Financial intermediation has declined slightly but the sector as a whole has so far weathered well the international financial crisis. Further measures have been taken to improve the quality of human capital.

However, in the context of the election period and the global economic crisis, the overall policy mix has deteriorated. The quality of public finances has declined, with a strong increase in public spending, notably in income transfers and subsidies and pensions, which rose well above inflation. This contributed to a sharp increase in external imbalances, while the public sector financing needs crowded out funds for private investment. Public sector debt has increased, but is still relatively low. FDI inflows decelerated markedly, largely due to the deteriorated international environment. Funds for addressing structural unemployment have remained limited, while unemployment remained very high. Institutional weaknesses and the rule of law need to be improved to allow for smooth functioning of the market economy. Further efforts are needed to strengthen public administration and the judiciary, in order to improve legal certainty and improve business environment. Regulatory and supervisory agencies sometimes still lack the sufficient independence and resources to fulfil their functions effectively. Despite efforts to reduce the unregistered economy, the issue remains an important challenge.

3. TURKEY

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

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The government submitted both the Pre-accession Economic Programme (PEP, 2009-2011) and the Medium-Term Plan (MTP, 2010-2012) after a delay of several months, thus maintaining the fiscal path uncertain. The government's MTP, which was announced in mid-September 2009, has taken into consideration both the current global crisis conditions and the improvements that are yet to come. The effectiveness of the various stimulus packages introduced in late 2008 and the first half of 2009 could benefit from a stronger fiscal anchor, a more credible framework and better communication and coordination. This will be even more important when growth resumes, and Turkey needs to present a credible and timely exit strategy from the current fiscal stimulus. *Overall*, under challenging circumstances consensus on economic policy essentials has been preserved; however, confidence in the government's economic policy stance could benefit from better planning, coordination and communication.

Macroeconomic stability

The negative effects of the global crisis on Turkey have gradually become evident. However, almost all economic indicators as of mid-2009 show that the economic contraction is bottoming out after it peaked in the first quarter of 2009. In 2008, the Turkish economy grew by 0.9% year-on-year, down from 4.7% in 2007. The contraction was particularly sharp in the last quarter of 2008 and in the first quarter of 2009, as GDP shrank by respectively 6.5% and 14.3% year-on-year. The pace of decline slowed sharply in the second quarter of 2009, to 7% year-on-year, and consequently the economy contracted by 10.6% in the year to the first half of 2009. The crisis affected adversely almost all sectors of the economy. The industry was particularly hit by a large fall in domestic and mainly in external demand, including for cars and electrical appliances. The downward trend in industrial production began to slow down as of March 2009. Consumer and business confidence, as well as capacity utilisation in industry started to show some positive signals since the end of the first quarter. On the demand side, private consumption and particularly private investment were affected severely by the crisis. In 2008, private consumption rose by a meagre 0.3% year-on-year, while private investment fell by 4% year-on-year. In the first half of 2009, the slowdown in investment accelerated sharply, and private investment fell by as much as 32.5%. Public consumption was supported by the fiscal stimulus packages and rose from 1.9% in 2008 to 2.7% in the first half of 2009. Private consumption started to respond to the fiscal expansion as it recovered strongly in the second quarter of 2009 and declined by 1.2% year-on-year compared with a 10.2% fall in the first quarter. Exports fell by 10.6% in the first half of 2009 following a 2.3% rise in 2008. Imports fell further, from -3.8% in 2008 to -25.9% year-on-year in the first half of this year. Stocks showed a sharp depletion and fell by 5% in the year to the first half of 2009. *Overall*, following the outbreak of the global economic crisis the Turkish economy has contracted sharply, in particular in the first semester of 2009, as a result of a combined and severe drop in domestic and mainly in external demand.

The current account went through a major adjustment as a result of a sharp drop in energy prices and very weak imports, due to lower domestic demand. Once considered as the main risk to the economy, given the implicit high financing needs, the current account deficit has become less of a concern. In the year to July 2009 the current account deficit stood at about 1.5% of GDP, and shows an improvement of some €18 billion from the level of €23 billion in the year to July 2008. However, a continuation of the recent increase in oil prices in US dollar terms may put pressure on the current account in the coming months. In spite of the fall in global liquidity, Turkey continued to have sufficient access to international capital markets, and was able to comfortably service its external obligations. During the reporting period, portfolio inflows virtually dried up and FDI was almost halved although they remained sizeable at roughly 1% of GDP. Despite the decline in economic activity rollover ratios of private sector external debt remained satisfactory and outperformed all market expectations in the year to September 2009. Furthermore, net errors and omissions, which is the balancing item of the balance of payments that is traditionally used for unaccounted flows in foreign currency, reached a cumulative €10 billion and covered a large part of the external financing needs. These errors and omissions apparently mainly reflect capital repatriation by residents, which was facilitated by a law adopted by the Turkish government at the end of 2008. Turkey's external debt declined by about 5% in nominal terms from the last quarter of 2008 until the first quarter of 2009 and currently amounts to about 40% of GDP. Private external debt represents two thirds of the total debt and is also on a declining trend. International reserves fell by about 5% to €50 billion, and still cover about 5 months of imports. *Overall*, external imbalances were reduced significantly, and access to external finance remained open for both the public and private sectors.

Table 3.1:
Turkey - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	9.4	8.4	6.9	4.7	0.9	-10.6
Private consumption	Ann. % ch	11.0	7.9	4.6	4.6	0.8	-5.7
Gross fixed capital formation	Ann. % ch	28.4	17.4	13.3	5.4	-7.1	-26.0
Unemployment	%	10.3	10.2	9.9	9.9	11.0	14.9
Employment	Ann. % ch	2.0	1.7	-0.4	-3.6	1.3	-1.1
Wages	Ann. % ch	10.2	12.4	11.0	9.5	11.3	11.8
Current account balance	% of GDP	-3.6	-4.6	-6.1	-5.9	-5.6	-2.1
Direct investment (FDI, net)	% of GDP	0.5	1.9	3.6	3.1	2.1	1.9
CPI	Ann. % ch	8.6	8.2	9.6	8.8	10.4	7.0
Interest rate (3 months)	% p.a.	24.29	16.74	18.07	18.85	18.04	12.72
Stock markets	Index	19,899	29,353	39,867	48,270	37,582	28,762
Exchange rate TRY/EUR	Value	1.77	1.67	1.80	1.78	1.91	2.15
Nominal eff. exchange rate	Index	26.8	28.1	26.2	26.7	25.8	n.a
General government balance	% of GDP	-4.5	-0.6	1.2	-1.0	-2.2	n.a
General government debt	% of GDP	59.2	52.3	46.1	39.4	39.5	n.a

Sources: Thomson Reuters/Ecowin

Due to the economic slowdown, the unemployment rate rose sharply from about 9.5% in mid-2008 to 13% by mid-2009. Unemployment was much higher among the young (about 24% of the age group 15-24). Long-term unemployed accounted for more than half of job-seekers. The employment rate went down by about 1 percentage point to about 42.5% by June 2009. Female employment also started to rise in 2008, but remains particularly low at less than 24% of total working-age population in June 2009. The agricultural sector is characterised by many unpaid family workers. This leads to a statistically lower rate of unemployment, but suggests large pockets of underemployment in this sector and in the economy at large. The working age population is growing by about 600,000 people every year, which implies significant challenges to the labour market absorption capacity, in particular in the current crisis context. In spite of recent initiatives, job creation remains difficult partly due to labour market rigidities and the skills mismatch between labour demand and supply. *Overall*, labour market conditions became increasingly challenging and the unemployment rate increased sharply in tandem with the sharp contraction in economic activity.

Annual inflation fell to 5.3% in August 2009 from 11.8% a year earlier, broadly in line with the inflation targets, and partly due to lower energy prices and shrinking domestic demand. Excluding unprocessed food and energy, underlying core inflation fell to 2% by August 2009. In addition, the foreign exchange pass-through has so far been minimal even though the Turkish lira depreciated considerably – by about 15% vis-à-vis the euro – in the first quarter of 2009. The Central Bank of Turkey (CBT) maintained the formal inflation targeting regime, which was adopted in January 2006, and appears to better anchor inflationary expectations than in previous years, largely helped by the domestic environment. The CBT acted in a timely and appropriate way by easing the policy rate by a cumulative 950 base points to 7.25% (in the period November 2009-September 2009) - which brought interest rates to unprecedented low levels - and by adding liquidity in the financial system. Credit to the private sector remained almost flat at around 28% of GDP, and is therefore not seen as a significant threat to price stability. *Overall*, price stability improved significantly, despite the considerable depreciation of the Turkish lira, mainly because pressures stemming from energy inputs and previously buoyant economic activity eased drastically.

The fiscal stance was loosened significantly, and the budget deficit amounted to 2.2% of GDP in 2008 (ESA95, April 2009 fiscal notification), thereby missing the 2008 fiscal target by over 1 percentage point. In the first eight months of 2009, revenues in the central budget were almost flat year-on-year, and spending was up 21% year-on-year, as the government introduced various fiscal stimulus packages. Part of the stimulus measures was outright current spending (i.e. around the date of local elections) in the form of increased transfers to households and local administrations, while others such as the tax relief and the investment schemes were better targeted at combating the crisis effects. Essentially, the tax relief consisted of lower or zero taxes for vehicles, white goods, furniture and IT equipment for a period of three months ending in June (which was subsequently extended until the end of September 2009). The cash deficit reached about 3% of the projected GDP in the period from January to August 2009, compared to a small surplus in the same period of 2008. Public debt (ESA95 definition) which had dramatically decreased in previous years as a result of the drastic fiscal consolidation pursued since the 2001 crisis remained broadly stable at 39.5% of GDP in the year to December 2008, but went up by almost 10% in nominal terms in the first half of 2009. The budget of 2009, as announced in the September 2009 medium-term programme, foresees a widening of the cash deficit to 6.6% of GDP. Moreover, the government increased the Treasury's borrowing limit by almost five times. *Overall*, although the anti-crisis measures may have cushioned the economic downturn, they could put benefits from previous years of fiscal consolidation and overall medium-term fiscal sustainability at risk.

Some key elements to enhance the accountability, efficiency and transparency of the budgeting process are still lacking. In particular, the earlier announced unification of all tax administration functions under the Revenue Administration has not been implemented. This unification would strengthen audit capacity and would facilitate increased use of standard risk-based audit techniques thereby enhancing transparency and providing significant support towards reducing informality. In addition, an off-budget fund has been created to finance losses in the agriculture sector. *Overall*, measures to increase fiscal transparency were put on hold and even reversed.

Over the past several years, Turkey had successfully implemented a strong stabilisation programme and the resilience of the Turkish economy benefited from in-depth structural reforms in many key areas, including banking, enterprise restructuring and privatisation, education and energy. Although the ongoing financial crisis has severely hit the Turkish real economy, the earlier regulatory and supervisory reforms are paying off and a full-fledged financial crisis has been avoided so far. However, the lack of more solid and credible fiscal anchors, in combination with the spending increases introduced since early 2009 to address the consequences of the crisis have increased uncertainty and may adversely affect the economic recovery. Fiscal consolidation has been reversed due to the ongoing crisis and the fiscal stimulus measures. *Overall*, although the current policy mix has proven broadly effective in the past months, macroeconomic stability remains vulnerable in the absence of stronger fiscal anchors.

Interplay of market forces

The private sector's share of GDP remained virtually constant at almost 89% in mid-2009. The Privatisation Administration completed the tender process for the privatisation of four regional electricity distribution networks, whereas one of them was suspended by the Council of State and another one failed due to the inability of contractors to secure financing. No progress can be reported in the privatisation of state-owned banks. The total volume of privatisation revenue reached €4.92 billion in 2008 (about 1.5% of GDP). In the first half of 2009, the privatisation revenue fell by about 42% and amounted to €1.6 billion. *Overall*, some progress has been made in improving the interplay of market forces. Privatisation has advanced, albeit at a slower pace due to the worsening external environment.

Market entry and exit

In 2008, the number of newly established firms decreased by 6%. During the same period, the number of firms which were closed down increased by 40%. Market entry in banking and capital markets remained restricted to mergers and acquisitions as new licenses have not been issued. Sectoral restrictions on foreign ownership continued to exist in various areas, including maritime transport, civil aviation, ground handling, road transport, radio and TV broadcasting, energy, accountancy and education. In the field of business environment, there was some improvement with regard to procedures to start up new business. A regulation was also published in order to accelerate customs procedures in some areas. However, licensing procedures, market exit, and the efficiency of bankruptcy proceedings are still cumbersome. Licensing procedures are relatively lengthy. For example 25 different procedures are needed in order to build a warehouse including getting licences and permits, completing necessary notifications and inspections and obtaining utility connections. Market exit is difficult as closing a business takes 3.3 years on average. The efficiency of bankruptcy proceedings is low: claimants recover only 20.2% of their claims from insolvent firms. *Overall*, market entry has benefited from the adoption of new legislation, while there are still obstacles in market exit. Restrictions on foreign ownership persist in some sectors.

Legal system

A reasonably well functioning legal system, including in the area of property rights, has been in place for several years. However, real estate acquisition by foreigners is still subject to some restrictions. No major progress has been made over the last year. However, a draft Judicial Reform Strategy Action Plan has been disclosed by the government in mid-2009 and sets clear priorities about the scope and targets of the ongoing reform. Registering a property requires six procedures and takes six days in Turkey. Enforcing commercial contracts remains a lengthy process, which needs 35 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 overall quality. Use of out-of-court dispute-settlement mechanisms remains low. *Overall* the legal environment, and in particular court procedures, pose practical challenges and create obstacles to a better business environment.

Financial sector development

The banking sector has shown remarkable resilience to the global financial crisis, largely due to major improvements in the regulatory and supervisory framework made in previous years. The financial sector's risk ratios remained robust. The sector benefited from the central bank’s liquidity measures and some easing of regulations governing loan classification and provisioning requirements. The capital adequacy ratio stood at a solid 18% by mid-2009, substantially higher than the EU legal requirement of 12%. Non-performing loans increased marginally to about 4.9% by mid-2009 from 3.0% a year earlier, and stress tests by the regulator show that the sector is sound and adapts well to the new challenges, in part through a wide-scale purchasing of debt instruments offered by the Treasury. The banking sector, by far the largest part of the financial sector, increased its share from 70% to 77%. The relative size of the insurance sector decreased slightly to 2.6%, about the same size as that of the mutual funds. Domestic private banks had a 34.5% share in total assets, whereas the share of foreign banks reached 37.4% taking into account foreigners’ investments in the stock exchange, which corresponds to 17.5% of banking sector assets. Financial intermediation improved in 2008, in particular in the banking sector, but weakened substantially in the first half of 2009. Since the Istanbul Stock Exchange fell considerably during 2008, total stock market capitalisation decreased from €195.3 billion (39.6% of GDP) to € 84.6 billion (19.1% of GDP). Concentration in the banking sector remained broadly stable, as the share of top-five and top-ten banks in the banking sector were 60% and 83%, respectively. *Overall*, under difficult crisis circumstances, the financial sector has shown remarkable resilience thanks to earlier reforms.

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

Existence of a functioning market economy

Macroeconomic stability has been tested and has been broadly preserved during the reporting period, in spite of the harsh economic recession. Financial markets stress and the absence of fiscal anchors added some uncertainty to the business environment but at the same time underlined the economy’s improved shock resilience. The investment climate has been adversely affected by the global economic and financial crisis, in particular in the absence of a consistent and coherent medium-term policy framework. *Overall*, the unfolding of the crisis did not jeopardise the functioning of market mechanisms and Turkey continues to be a functioning market economy.

Human and physical capital

The quality of education remains an important problem in Turkey, although the results are improving. The net enrolment rate in compulsory education (8 years) increased by almost 10% to over 97%. The net enrolment rate in secondary education also increased, from 56% to 58%. The net enrolment rate in universities increased from 19% to 20% but remains low by international standards. Little progress has been made in correcting the mismatch between supply and demand of skills on the labour markets, which largely stem from inadequate education and training.

Total investment slightly increased as a share of GDP from 21.5% in 2007 to 22.1% in 2008, but has declined significantly in the reporting period as private investment collapsed due to the crisis. On the other hand, as a result of the fiscal stimulus package, public investment has increased by around 25% in annual terms in the first quarter of 2009. FDI inflows held out relatively well in the first four months of 2009 helped by privatisation of the electricity grid and declined by about 40% compared to a year earlier. At the same time, their composition improved as more than two thirds went into utilities and manufacturing. The domestic savings rate increased from 15.6% of GDP in 2007 to 16.4% in 2008, in particular because of the positive impact of the change in stocks (1.8% of GDP). 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. However, in 2007 and 2008 some, albeit modest, progress can be reported for infrastructure, in particular in the area of roads and oil pipelines. Most importantly, the Nabucco intergovernmental agreement was signed in July. Nabucco is a natural gas pipeline project which will bring natural gas from the Caspian region and the Middle East to Turkey and Europe, and is of strategic importance for the energy security of both Turkey and the EU. A high-speed rail line between Ankara and Eskisehir became operational during the reporting period. Implementation of the National Development Plan (2007-2013), and in particular of the South-eastern Anatolia Project, suffered from falling investor interest due to the current exceptional crisis circumstances. *Overall*, some progress was made in upgrading the country's human and physical capital, although the economic crisis represents a new challenge to this process. The signature of the Nabucco natural gas intergovernmental agreement represents an important economic and strategic development.

Sectoral and enterprise structure

The independence of regulatory and surveillance agencies has been largely preserved. Market liberalisation has not been advanced in agriculture, whereas some progress has been made in energy. The sectoral shift from agriculture to the services and industry sectors appears to have been temporarily reversed due to the slowdown in economic activity. The share of agriculture in overall employment increased from 24.0% to 24.6% between December 2007 and December 2008. The share of services also increased from 49.5% to 50.2%. On the other hand, both the industry (from 21.0% to 19.7%) and construction (from 5.5% to 5.4%) sectors experienced a decline in their relative shares of total employment.

The quality and publication frequency of data on small and medium-sized enterprises (SME) remained poor. Various new initiatives have been launched to improve the access of SME to finance. However, the share of SME in total banking sector loans decreased from 27.7% in December 2007 to 22.8% in February 2009. Informality remains widespread throughout all corporate sectors, particularly amongst SME. Turkey adopted a comprehensive action plan to combat the informal economy. The authorities approved new legislation in May 2009, which allows the SME support organisation KOSGEB to provide assistance not only to manufacturing SME but also to enterprises that are active in trade and services, while a new guarantee fund for SME was part of the stimulus packages and aimed at alleviating the impact of the current crisis on SME finances. *Overall*, in spite of various new initiatives by the Turkish government, the economic crisis is complicating the access of SME to finance and slowing down the sectoral transformation of the Turkish economy**.**

State influence on competitiveness

There has been no tangible progress in the field of state aid. As transparency in the decision making process remains low, it is difficult to assess the rationale and consistency of the individual decisions taken. In addition, the size of state aid and its importance in some key sectors increased substantially following the introduction of the various fiscal stimulus packages. Transparency in the corporate sector has improved and accounting standards have been upgraded, although the adoption of the Commercial Code has again been postponed. The absence of transparent monitoring of state aid and of supporting policies to reduce distortion continued to have an adverse effect on competition and competitiveness in the economy. Public procurement policies continued to be undermined by exceptions to the regulatory framework. *Overall*, state intervention continued to lack transparency, which may have negatively affected competition and competitiveness.

Economic integration with the EU

The openness of the Turkish economy, as measured by the total value of exports of goods and services as a percentage of GDP, amounted to about 48% of GDP in 2008, almost unchanged from 2007. Exports to the EU rose by only 5% in 2008, whereas exports to other countries, mainly Turkey's neighbours in the east and the south, rose by 49%. Only 48% of Turkey's exports went to the EU, compared to 56% a year earlier. Imports from the European Union rose by only 9% in 2008 whereas imports from other countries rose by 25%. EU share in Turkey's trade varies slightly from year to year, depending on numerous factors, including commodity price trends and exchange rate movements. Nevertheless, the decline in the EU share in 2008 is probably related to the relatively more drastic impact of the global crisis on demand in EU markets. As a result, Turkey became less dependent on European Union markets and diversified parts of its trade towards other neighbouring countries. FDI inflows to Turkey originating from EU member states remained very significant, and proportionally grew from 75% of the total in 2008 to 88% in the first five months of 2009, thus illustrating the strong economic interdependence between the EU and Turkey. *Overall*, trade and economic integration with the EU remained high. Turkey showed remarkable flexibility and diversified its trade towards new markets, thereby partly alleviating the impact of the crisis.

Based on the scant information on real wage developments, it appears that unit labour costs have increased broadly at a similar pace as labour productivity. Indicators of export price competitiveness have improved significantly as the Turkish lira weakened considerably vis-à-vis the euro and the US dollar. In the year to September 2009, the exchange rate of the lira depreciated by 15% against a basket of 50% US dollar and 50% euro in nominal terms. In real effective terms, corrected for both, producer and consumer price developments, the lira weakened by 13%. *Overall*, Turkey made significant gains to price and cost competitiveness vis-à-vis its main trading partners.

3.3. CONCLUSION

The economy of Turkey contracted following the drop of both external and domestic demand, in particular investment. However, the impact of the crisis was largely limited to the real sector of the economy also due to previous structural reforms and countercyclical measures. Macroeconomic stability has been largely preserved. Inflation decreased significantly, mainly because pressures stemming from energy inputs and previously buoyant economic activity eased. Unemployment increased significantly. In a difficult economic environment, the structural reform process has somewhat decelerated, in particular in the first half of 2009. The absence of credible fiscal plans and anchors added some uncertainty to the investment climate.

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

The consensus on economic policy essentials has been maintained under the current challenging circumstances. Turkey accommodated demands for expansionary policies to counter the marked economic contraction and largely embedded them in a broader development strategy entailing higher public investment, job creation and sectoral reforms. Some progress was made in upgrading the country's human and physical capital, although the economic crisis represents a challenge to this process. Access to external financing remained open and the official reserves declined only moderately from a high level. External imbalances were reduced significantly and inflationary pressures subsided. Privatisation continued with some major operations, in particular in the energy sector. In spite of several bouts of global financial instability, the Turkish financial sector has shown remarkable resilience. Turkey diversified its trade towards new markets, thereby partly alleviating the impact of the crisis.

However, while the anti-crisis fiscal measures cushioned somewhat the economic downturn, they could put benefits from previous years of fiscal consolidation and medium-term sustainable policies at risk if they are not withdrawn timely. Measures to increase fiscal transparency were put on hold and even reversed in some cases. Labour market conditions became increasingly challenging and unemployment increased sharply. Job creation continued to be hampered, notably by a skills mismatch between labour demand and supply, relatively high social contribution rates and by the rigidity of employment practices. In spite of various new initiatives by the Turkish government, the economic crisis is complicating the access of SMEs to finance and slowing down the sectoral transformation of the Turkish economy. The allocation of state aid continued to lack transparency. While market entry has benefited from the adoption of new legislation, there are still obstacles in market exit. The legal environment, and in particular court procedures, pose practical challenges and create obstacles to a better business environment. Turkey adopted a comprehensive action plan to reduce the informal economy, which remains an important challenge.

4. ALBANIA

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

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In February, Albania submitted its third Economic and Fiscal Programme for 2008-2011. The programme presents a coherent set of economic policies and aims at consolidating public finances. Albania's medium-term macroeconomic and fiscal framework was revised in May in order to update the external assumptions and better reflect the impact of the global economic crisis. The 2009 growth estimate was revised downwards. The programme reflects an improved budget and project planning capacity, as well as better availability of statistics. The document is well integrated with other medium-term planning instruments such as the Medium-Term Budget Programme 2009-2011 and the National Strategy for Development and Integration 2007-2013. In July 2009, the government adopted the Medium-Term Budget Programme 2010-2012. The regular use of these medium-term planning instruments indicates that administrative planning and implementation capacity has improved. Albania completed its three year 2006-2009 PRGF/EFF([1]) programme with the IMF in January 2009 and so far has not requested a new programme**.** *Overall*, consensus on the fundamentals of a market-oriented economy was maintained.

Macroeconomic stability

The Albanian economy recorded strong and sustained growth of 8% in 2008 and, according to the authorities' data, of 6% in the first quarter of 2009, mainly driven by large public investments in the road network. Private sector activity benefited from strong, albeit slowing, credit growth, and from improved stability of the energy supply. So far, the international financial and economic crisis has resulted in lower demand for Albanian exports, a fall in net inflows of monetary transfers in the form of remittances, and a marked slowdown in credit growth. Per capita GDP in purchasing power parities was estimated at 25% of the EU-27 average in 2008, up from 24% in 2007. *Overall*, the Albanian economy continued to grow, albeit at a slower pace.

The current account deficit widened in 2008 to 14.5% of GDP, up from 10.5% of GDP in 2007, reflecting a further deterioration of the trade deficit and a decline of remittances. The trade deficit in 2008 increased to 27.2% of GDP from 26.5% of GDP in 2007. Partly due to the massive public road works, imports of capital goods increased by 29% as compared to 2007. Consumption goods imports decreased by 6% in 2008. Albanian exports continued to show strong dependency on apparel industries, which accounted for 43% of total exports. Exports of mining products grew substantially in 2008 but suffered a severe setback in 2009, partly due to lower international demand for chromium and nickel. In the first half of 2009 exports fell by 21% year-on-year, and the exports-over-imports coverage ratio fell to 25.5%, down from 30.8% in the first half of 2008. Remittances were down by around 16% in 2008 compared to 2007, amounting to 9.2% of GDP, partly reflecting the impact of the global financial crisis, partly the declining trend observed over the past years. Latest data for the second quarter 2009 point to a further decrease of remittances of 4% compared to the same period in 2008.

([1]) Poverty Reduction and Growth Facility and Extended Fund Facility.

Table 4.1:
Albania - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	5.7	5.7	5.4	6.0	8.0	n.a
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Unemployment	%	14.7	14.3	13.9	13.3	12.8	12.7*
Employment	Ann. % ch	-0.4	0.9	0.2	0.2	2.9	3.6*
Wages	Ann. % ch	15.3	9.9	7.5	17.1	8.3	10.0*
Current account balance	% of GDP	-5.8	-8.9	-6.6	-10.6	-14.8	-15.3
Direct investment (FDI, net)	% of GDP	4.5	3.2	3.5	6.0	6.6	8.1
CPI	Ann. % ch	N.A.	N.A.	N.A.	2.9	3.4	2.0
Interest rate (3 months)	% p.a.	6.78	5.55	5.49	5.92	6.24	6.15
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Exchange rate LEK/EUR	Value	127.17	123.73	122.76	123.31	122.39	129.51
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
General government balance	% of GDP	-5.1	-3.6	-3.2	-3.5	-5.5	n.a
General government debt	% of GDP	56.6	56.7	55.7	53.8	n.a	n.a

Sources: Thomson Reuters/Ecowin * Q1

External imbalances remained high and continued to widen. In 2008 net capital inflows covered the current account deficit and contributed to the foreign reserves' increase. Net FDI increased by about 42%, reaching the level of 7% of GDP, up from 5.9% in 2007, with an increasing share of greenfield investment. During the first half of 2009, a tender for a syndicated loan of up to €250 million was awarded to a consortium of foreign banks. If fully drawn, the loan would finance about 30% of public investment in 2009. The public external debt ratio increased to 18.4% of GDP in 2008 from 15.4% of GDP in 2007. Corporate foreign financing remained negligible. Albania preserved a sufficient level of international reserves at around 4.2 months of imports. *Overall*, strong capital inflows more than financed a large current account deficit in 2008, and they continued during the first half of 2009, partly driven by the privatisation process.

The unemployment rate decreased slightly to 12.7% by the end of 2008, down from 13.2% by the end of 2007. Public wages increased by 8.8% in 2008, whereas the average wage in the private sector increased by 15.1%. A further increase in public sector wages and pensions took place in May 2009. *Overall*, there were some improvements in labour market outcomes. However, unemployment remained high and labour market data continued to be poor.

Price stability was maintained. The annual average inflation rate rose to 3.4% during 2008 from 2.9% in 2007, but remained within the Bank of Albania's target range of 2-4%. The main contributors to inflation were international food and fuel prices as well as domestic energy prices. Inflationary pressure started fading out in the third quarter of 2008 in line with slowing money supply growth. The inflation rate continued its declining trend during the first three months of 2009, reaching 1.6% in March, and thereafter slightly resumed and stabilised at 2.2% in July and August. In view of subsiding inflationary pressures and as a reaction to the international financial crisis, the Bank of Albania reduced its basic policy rate from 6.25% to 5.75% in January and started providing unlimited liquidity to banks at its current policy rate. Deposit withdrawals reduced the stock of deposits by 8.2% between September 2008 and April 2009. Thereafter, deposits started growing again as of May 2009. The increase of the state deposit insurance to 100% coverage of deposits of up to 25 million lek (about €20,000) was a stabilising element. Albania continued to pursue a free floating foreign exchange regime. In 2008, the lek appreciated by 0.7% and 7.2%, respectively, against the euro and the US dollar, while it depreciated against both currencies in the first half of 2009 by 6.5% vis-à-vis the euro and 4.5% vis-à-vis the US dollar. *Overall*, monetary policy remained sound, maintaining price stability and ensuring the liquidity of the banking sector after the outbreak of the crisis. Inflation remained within the target range.

During 2008, the tax administration made further progress in both general revenue collection and administrative reforms. Tax revenues increased to 24.3% of GDP up from 23.2% of GDP in 2007. The application of the 10% flat personal income tax continued to produce effects in 2008 and led to a sharp increase in income tax revenues. However, revenue collection at local government level remained low. Public expenditures in 2008 increased to 32.3% of GDP due to accelerated capital expenditures, reaching 8.6% of GDP in 2008 after 5.8% of GDP in 2007, mainly reflecting public investment projects such as the Durrës-Kukës road. 98% of budgeted capital expenditures was actually spent, signalling improved project planning and implementation capacity. However, there were also costs overruns in the particular case of the Durrës-Kukës road. Domestic public debt remained at 36.7% of GDP, whereas foreign public debt increased to 18.4% of GDP as compared to 15.4% in 2007. Higher interest payments partly reflected the strategy to lengthen the maturity structure of Albania's public debt.

The fiscal policy stance continued to be expansionary in 2008, as in the previous year. Fiscal imbalances deteriorated, with the total budget deficit increasing to 5.5% of GDP in 2008. The 2009 budget initially projected a deficit of 4.2% of GDP, based on a GDP growth rate of 4.8%. The budget includes a contingency line of approximately 2% of GDP, to be used to address fiscal downside risks. It has, however, already been partly used to fund the rise of public wages as from May 2009. Fiscal revenues performed well during the first five months of 2009, with total revenues up 8.1% in annual terms. Nevertheless, since the 2009 budget had originally been based on a more favourable macro-fiscal framework, total revenues were 6% behind schedule. As a consequence a revised budget was prepared in summer and approved by the Parliament in September, with an increased deficit of 6.4% of GDP for 2009. The financing of fiscal deficits continued to put a floor under the level of interest rates for business and consumer loans and to divert savings to the government sector, thereby hampering growth. The government relies in 2009 on privatisation revenues and borrowing to finance the deficit, to an extent that does not appear sustainable over the medium-term. *Overall*, fiscal policies continued to sustain growth but will need to be reassessed to ensure long-term sustainability of public finance**.**

Overall, macro-economic stability has been maintained, as the crisis has had only a limited impact on the country. Monetary policy reacted to the changes in the economic environment and ensured liquidity of the banking system, while contributing to low inflation and exchange rate stability. On the fiscal side however, while budget planning improved, significant budget imbalances remained an element of vulnerability.

Interplay of market forces

The private sector employed about 83% of the workforce in 2008, reflecting a slight increase versus 2007. State participation in the economy diminished further as Albania made good progress with the implementation of its privatisation agenda. In December 2008, the oil refinery company ARMO was sold for € 128 million. The remaining state-owned shares in the mobile telecommunication company AMC were sold for € 40 million in February 2009. 76% of the shares in the distribution arm of energy company KESH were sold for € 102 million in April partly implementing a key European Partnership priority. A fourth mobile communication company was licensed in April 2009 for € 7.2 million. In May 2009, the World Bank approved a Partial Risk Guarantee of €60 million for the privatisation of KESH's distribution arm. *Overall*, the government made good progress in reducing the level of state ownership in the economy.

Market entry and exit

The National Registration Centre became fully operational and registered close to 18,000 new businesses in 2008, an increase of 29% over 2007. The one-stop-shop national centre for licensing took up its operations in June 2009, and substantial progress was made on reform and simplification of licensing. In February 2009 the Urban Planning Law was amended reducing the time for issuing construction permits from 60 to 45 days. The documentation for issuing property titles for several thousands of applicants was prepared, but unresolved legal issues with regard to the compensation of former owners continued to hamper this process. No cases of implementation of the Bankruptcy Law were reported. *Overall,* good progress was made to further facilitate market entry. However, bankruptcy procedures are still not used, which hampers the efficiency of market mechanisms.

Legal system

The role of courts in the enforcement of contracts remains limited and the legal system at large lacks authority and public acceptance, partly due to perceived levels of corruption and weak administrative capacity. Informal methods of contract enforcement, by-passing the legal system, continued to be widespread. In January 2009, the government introduced the obligation to use online public procurement procedures, but the Law on Administrative Courts has not yet been approved by parliament. Administrative procedures have impaired the implementation of the Tax Amnesty Law. By the end of 2008, a State Commission was established to verify all property titles distributed according to the Law on Land and regional commissions were established at the 'prefecture' level to verify the cases, further slowing down land ownership transactions. *Overall*, the legal system did not contribute as required to the enforceability of contracts and to the strengthening of the rule of law. Limited progress was made towards the establishment of clear, well defined land property rights.

Financial sector development

After the privatisation of the remaining 40% of state-owned shares in United Bank of Albania, the banking sector is totally private-owned. External borrowing by the banking sector stood at 8.6% by the end of 2008 and increased further during the first half of 2009. Bank lending to the private sector increased in 2008 to 34.4% of GDP, which still leaves financial intermediation at a low level. The interest rates charged by commercial banks for business and consumer loans continued to be driven by interest paid on government securities. The average yield of 12-month Treasury bills stood at 8.8% at the end of 2008, up from 8.4% a year before, and continued to increase to 9.24% by end of June 2009. As a consequence, public financing needs effectively continued to crowd out private investment. *Overall*, banks continued to provide the full range of business loans. However, the share of other financial intermediaries remained low.

The Bank of Albania stepped up its supervision of the banking sector in areas related to credit risk management, capital adequacy, risk management by subsidiaries of foreign banks, and risk management in the context of large exposure. To support liquidity in the banking system it limited amounts that foreign-owned bank subsidiaries can deposit with their parent institutions. As the international economic crisis started showing effects on the export sector, the share of non-performing loans increased from 4% in March 2008 to 7.5% in the first quarter of 2009. Business loans were on average more problematic than consumer loans, with a non-performing loans ratio of 7.6% by the end of 2008, up from 3.6% by the end of 2007. Also profitability indicators, having remained solid throughout 2008, came down markedly during the first quarter of 2009. Finally, in April, the banking sector, taken as a whole, recorded its first net financial loss in several years. *Overall*, the banking sector remained well-capitalised and liquid. However, in the first half of 2009, as the international economic crisis started showing effects, profitability suffered as non-performing loans increased, and banks started to tighten criteria for awarding credit thus dampening credit growth.

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

Existence of a functioning market economy

Macroeconomic stability was maintained in a very challenging economic environment. There were improvements in the organisation and accessibility of the national land registry, which includes the registration of property; the reliability of the credit registry was further improved, and no severe energy supply shortages were observed over the last year. *Overall*, there has been good progress towards establishing a functioning market economy. However, uncertainty about property rights, poor contract enforcement and outstanding shortcomings in the rule of law remained main obstacles.

Human and physical capital

The government continued its strategy to improve the quality of human capital, the so-called ‘brain gain’ initiative. Persons holding university degrees at either masters or PhD level were offered premiums on top of public salaries, with degrees earned at universities abroad allowing for higher premiums. 8,000 young people were trained in the vocational training schools and new vocational training posts were opened during the year 2008. However, impact assessments of measures to improve the functioning of the labour market are impaired by the absence of reliable labour statistics.

Gross fixed capital investment stood at 39.1% of GDP, with private sector investment taking a slightly smaller share of 29.8% of GDP, down from 30.5% in 2007. Net FDI increased by about 42%, reaching the level of 7% of GDP, up from 5.9% in 2007, with an increasing share of greenfield investment. Public investments focused on road infrastructure. The Vlora thermal power plant is not yet operational, whilst a series of concession agreements for the construction of hydro-power electricity generation plants were approved. *Overall*, there has been substantial investment in infrastructures, notably in the transport sector, although shortcomings remain.

Sectoral and enterprise structure

The changes in relative shares of agriculture, industry and services were similar to previous years. Roughly half of Albanian GDP is produced in the service sector. Agriculture continued to downsize but still represented a 16.3% share of GDP and remained the largest employer with 58% of the working population. The secondary sector expanded on the back of large infrastructure works. 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. Reducing its size remained an important challenge and government efforts to address high levels of informality continued by reducing taxes for businesses and employers’ social contributions. The energy supply was more reliable during the reporting period. However, Albania is still mainly dependent on hydro-electric power and security of supply remains uncertain. The energy sector continued to exhibit high rates of technical and non-technical losses. The energy market became also more competitive with the privatisation of ARMO. A number of concessions were awarded for new hydro-power plants as well as to build wind farms. *Overall,* restructuring of the energy sector progressed. However, security of electricity supply remains uncertain.

State influence on competitiveness

Direct subsidies in the form of transfers from the budget remained negligible (0.2% of GDP in 2008 and 2009). With regards to indirect subsidies, electricity tariffs are not yet at cost recovery levels and the debt of the privatised Distribution Systems Operator was transferred to publicly owned KESH. *Overall*, state interventions were kept within bounds.

Economic integration with the EU

The openness of the Albanian economy continued to increase. The sum of imports and exports (conventionally defining openness) stood at more than 82% of GDP in 2008. Total foreign trade increased by 16% compared to 2007. Both imports (+15.3%) and exports (+16.5%) of goods and services grew during 2008, albeit at lower rates than in 2007. Albania's main trade partners continued to be Italy and Greece. *Overall,* the EU remained the main trading partner of Albania in 2008, and trade with CEFTA countries increased. However, the poor sectoral diversification of trade leaves the economy vulnerable to sector-specific shocks.

4.3. CONCLUSION

The economy of Albania maintained macroeconomic stability against the background of the international financial and economic crisis. Throughout 2008 economic growth continued to accelerate, but it slowed down in 2009 as a consequence of reduced exports, remittances and credit growth. Monetary policy remained sound and price stability was maintained. However, an expansionary fiscal policy, while including much needed public works on the road network, resulted in a high budget deficit. Shortcomings in the rule of law, poor level of infrastructure and the informal economy remain challenges to economic development and the business environment.

As regards the economic criteria, Albania has made good progress towards establishing a functioning market economy. In order to enable it to cope over the medium term with competitive pressure and market forces within the Union, Albania needs to reform and strengthen its legal system and address weaknesses in infrastructure and human capital.

The government reacted to the international crisis using the full range of monetary and fiscal instruments, as well as regulatory measures. Strong capital inflows, partly driven by the accelerated privatisation process, were more than sufficient to finance the current account deficit. The continued implementation of tax administration reform broadened the tax base, increased overall tax compliance, and helped reduce the informal sector. More efficient tax collection contributed to a surplus in the primary budget balance and improved the policy-mix in 2008. The level of state ownership in the economy was further reduced, notably in the energy and telecommunication sectors. Market entry was further facilitated and market participants benefited from improved property and credit registries. In a difficult international environment, the banking sector remained well-capitalised and liquid. Large scale public works improved the road network.

However, the expansionary fiscal policy during the election period resulted in high budget deficit in 2008 and the forecasted deficit for 2009 remains high. Additional efforts in consolidating public finances are necessary. Bankruptcy procedures are still not being used. Weak administrative capacity undermines the authority and acceptance of the legal system. Informal methods of contract enforcement, by-passing the legal system, continue to be widespread. Unresolved property issues continue to undermine the development of a functional land market and keep investments below potential. The informal sector remains an important challenge. Unemployment remains high. The education system is in need of major reform. Transport infrastructure remains poor and security of electricity supply is still not fully ensured due to the lack of diversification of generation and poor interconnection capacity.

5. BOSNIA AND HERZEGOVINA

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

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In January 2009 the authorities submitted their third Economic and Fiscal Programme for 2009-2011. However, in view of large uncertainties concerning the global economic situation and its impact on Bosnia and Herzegovina at the time of drafting, it retains only limited relevance as a core document for economic policy making. Faced with the economic crisis and the legacy of poor fiscal policies, the authorities, represented by the National Fiscal Council, concluded in early May 2009 negotiations with the International Monetary Fund on a Stand-By Arrangement that comprised commitments to a number of structural reforms and fiscal adjustment measures. Subsequently, the National Fiscal Council approved a three-year budget framework for 2009-2012 in June. Following the fulfilment of further agreed prior actions, the IMF board approved in July 2009 the € 1.15 billion loan for a three-year period. In general, differences between the entities on economic and fiscal policy essentials continue to exist. The commitment to pursue structural reforms has remained weak, particularly in the Federation. The quality of public spending has deteriorated in both entities. *Overall,* the commitment to structural reforms and sound public finances remained uneven across the country. The coordinating and decision-making role of the National Fiscal Council was however somewhat strengthened and the general consensus on a market-based economy was kept.

Macroeconomic stability

In 2008, real GDP growth fell to 5.4% from 6.8% recorded in 2007. The recovery of the electricity sector contributed largely to growth. The country's growth model was characterised by high domestic demand, fed by rapid credit growth, external financing and expansionary fiscal policies that fuelled macroeconomic imbalances, not least a widening current account deficit. The global economic and financial crisis started to reveal its impact on Bosnia and Herzegovina in the last quarter 2008. Economic activity decelerated and unemployment picked up. Trade dynamics slowed drastically because of reduced demand and financial stability was threatened in October 2008 when more than 6% of deposits were withdrawn. Per capita income, measured in purchasing power standards (PPS), was 30% of the EU-27 average in 2008, up by one percentage point compared to the previous year. While the situation in the domestic financial market stabilised quickly due to an appropriate, quick and flexible reaction of the Central Bank, the slowdown of economic activity continued in 2009 as a result of lower domestic and external demand, reduced financing and falling foreign direct investments. The Federation registered a drop of industrial production of 10.5% annually in the first eight months. In Republika Srpska, however, it increased by 16.7% which is to a large extent due to the re-opening of an oil refinery in December 2008. In an attempt to mitigate the effects of the economic crisis on the budgets, the National Fiscal Council unblocked some € 90 million in the first quarter of 2009 from succession funds of former Yugoslavia's assets. Nonetheless, this proved to be insufficient as public finances increasingly came under stress as the result of falling revenues and high spending commitments. Therefore, the authorities finally turned to the IMF for external support. *Overall*, with the crisis unfurling economic growth declined towards the end of 2008 and this trend continued in 2009, leading the country into recession.

The current account deficit widened to 14.7% of GDP in 2008, up from 12.7% in 2007, driven by worsening terms of trade and developments of global prices and internal demand during the first half of 2008. It was financed more or less equally by foreign direct investments and drawings of new loans from abroad. The already very high trade deficit still slightly grew to 38.1% of GDP in 2008 (goods only), up from 37.4% of GDP in 2007. The development of other components of the current account showed reversing trends as compared to previous years: The income balance increased by only 3.5% (24% in 2007) and current transfers fell by 6.7% (after an increase of 11.3% in 2007), mainly because of remittances falling by 4%. Nevertheless, transfers still represent the major offset to trade within the current account. The monthly trade deficit improved for the first time in more than two years in November 2008. This trend continued as in the first half of 2009 the drop in imports (25.3%) exceeded that in exports (23.4%), resulting in an improvement of the trade deficit by 26.7% year-on-year. The current account deficit more than halved year-on-year in the first quarter. This drop was mainly due to developments in trade, but also a slightly rising current transfer balance contributed to it. Bosnia and Herzegovina's external public debt increased by 5.5% in 2008 and by a further 1.4% in the first half of 2009, but still stands at a relatively low level of 17.5% of estimated GDP. Private external debt reached 27.4% of GDP in 2008. Official foreign exchange reserves declined by 16.8% up to June 2009 from their peak in September 2008, before they recovered again as a result of the first tranche of the IMF support being disbursed in July. They cover more than five months of imports. *Overall*, external imbalances are adjusting in the context of the crisis, characterised by a rapid narrowing of the current account deficit towards a more sustainable level.

Table 5.1:
Bosnia and Herzegovina - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	6.3	3.9	6.9	6.0	5.4	n.a
Private consumption	Ann. % ch	N.A.	6.2	8.3	13.4	n.a	n.a
Gross fixed capital formation	Ann. % ch	N.A.	18.5	-7.6	37.0	n.a	n.a
Unemployment	%	43.1	44.7	44.2	42.9	40.6	41.1
Employment	Ann. % ch	0.8	0.8	2.3	4.4	2.7	-3.7
Wages	Ann. % ch	4.3	6.1	9.6	9.8	16.6	11.9
Current account balance	% of GDP	-16.3	-17.3	-7.9	-10.4	-14.9	n.a.
Direct investment (FDI, net)	% of GDP	7.0	5.7	5.8	13.7	5.7	n.a.
CPI	Ann. % ch	0.5	4.3	6.1	1.5	7.4	0.3
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Stock markets	Index	N.A.	N.A.	N.A.	4,330	2,251	1,015
Exchange rate BAM/EUR	Value	1.94	1.95	1.95	1.94	1.94	1.94
Nominal eff. exchange rate	Index	93.0	100.0	99.7	100.3	100.1	96.3
General government balance	% of GDP	1.6	0.8	2.2	-0.1	-4.0	n.a
General government debt	% of GDP	25.6	25.7	21.3	29.8	27.8	n.a

Sources: Thomson Reuters/Ecowin

The already high rate of registered unemployment further increased in the first half of 2009 to 41.6% in June from 40.6% at end-2008. Sectors with the highest annual growth of employment were financial intermediation, public administration, health and education, while employment decreased in manufacturing, mining, agriculture and trade. According to the Labour Force Survey following ILO methodology, unemployment increased to 24.1% in 2009 from 23.4% in 2008. The discrepancy between the two measurement methods points to a high importance of informal activities. 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 – continue to hamper job creation and labour market participation. The corresponding key European Partnership priority has not been addressed. *Overall*, unemployment remains very high and slight improvements recorded throughout 2008 have started to be offset by negative developments since the beginning of the economic downturn.

Annual inflation became negative in May 2009 and stood at -1.2% in July, down from its peak of nearly 10% a year earlier. The 12-month moving average inflation rate fell to 2.9% in July, compared to 7.4% in 2008. The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the anchor currency. In response to the turmoil on financial markets in the fourth quarter 2008 the Central Bank increased the liquidity of the banking system in several consecutive steps by lowering the minimum reserve requirement rate, with the aim of strengthening and restoring confidence in national financial markets and of stimulating credit activities. As of November 2008 all new credit lines from abroad by commercial banks ceased to enter into the basis for required reserves calculation and the minimum rate was set at 14%, down from 18%. As of January 2009, the required reserve ratio on term deposits with a remaining maturity of more than one year was further lowered to 10% and to 7% in April. In line with reduced demand, the monetary aggregate M2([1]) declined by 6.7% between September 2008 and July 2009, showing positive trends in recent months. *Overall*, the currency board has continued to function well and proved its stability under difficult circumstances.

The share of general government in GDP remains high with 2008 revenues at 46% of GDP and expenditures at 50% of GDP, thus creating a budget deficit of 4% of GDP in 2008, down from near-balance in 2007. Revenue weakened in 2008, while expenditure rose sharply, driven by increases in wages and social benefits. The increase in the public sector wage bill – which stood at 12% of GDP in 2008 on a consolidated basis – was high, particularly in Republika Srpska where it reached 36.4% in 2008 (16.4% in the Federation). Social benefits increased by 26.5% in Republika Srpska and 30.4% in the Federation and stood at a consolidated 10% of GDP in 2008. In the Federation, transfers to households almost doubled in nominal terms. Bosnia and Herzegovina spends a very high share of 4% of GDP on non-insurance social protection cash transfers. At the same time, there was a slowdown of investment expenditure to 6% of GDP in 2008 from 6.7% in 2007. The Federation introduced a 10% flat personal income tax rate as of 1 January 2009. In the context of the IMF programme, some excise taxes were increased as of 1 July 2009. The system of generous non-targeted benefits for war veterans, demobilised soldiers and other social groups and their wide-spread misuse continued to be a drag on the budget, especially in the Federation where they absorb approximately one third of the budget. In the context of the IMF programme it was agreed to replace this highly inefficient system by a means-tested scheme over the medium-term. The lack of progress with the privatisation agenda in the Federation – receipts amounted to only € 1.5 million in 2008 and € 0.6 million in the first half of 2009 – further undermined the entity's financial health. In April 2009, the Federation rebalanced the budget upward, increasing its volume by 19% in order to reflect the planned borrowing for the coverage of the 2008 budget deficit. A second rebalance in July included the adjustment measures agreed with the IMF, such as the Intervention Law cutting wages and social transfers by 10%. Following the agreement with the IMF, Republika Srpska rebalanced its budget and lowered its volume by 4.2%. In the first half of 2009 consolidated revenues of entities and state level decreased by 9.8% compared to the same period of the previous year, mainly as the result of falling custom duties and VAT revenues. Despite the agreements reached on coefficients for re-distribution, the allocation of indirect tax revenues to the state, entities and the Brčko District remains a controversial issue. *Overall*, the quality and sustainability of public finances has further deteriorated, especially in the Federation.

General government debt comprising all levels of government stood at 27.8% of GDP in 2008, down from 29.8% in 2007. In the course of 2009, public debt has increased substantially due to significant budget deficits and the loan agreement with the IMF. In 2008 internal public debt managed and served by the entities amounted to about 11% of GDP. Both entities and the Brčko District have issued bonds in order to repay these claims. With the Law on Debt, Borrowing and Guarantees in the Federation the

([1]) M2 comprises currency outside banks and demand and time and savings deposits in both domestic and foreign currency.

legal framework has improved and the limitation of debt service in relation to revenues in the Federation contributes to the long-term sustainability of public finances, similar to provisions in place in Republika Srpska and at state level. However, the institutional capacity for debt management remains weak. *Overall*, while public debt remained at acceptable levels and even decreased in 2008 it has substantially increased in 2009.

Improvements in the overall macroeconomic policy mix are still needed. On the one hand, the currency board arrangement enjoys a high level of confidence and credibility. In addition, the economic downturn has resulted in the necessary adjustments of external imbalances. On the other hand, the actual fiscal situation has worsened and adjustment efforts are uneven across the country. *Overall,* the viability of macroeconomic policies suffered from worsening public finances which finally led to the need for an IMF programme, even though external imbalances have started to improve in the context of the global economic crisis and financial and monetary stability has been preserved.

Interplay of market forces

The private sector's share in GDP remained stable at around 60% in 2008. After the large privatisations in Republika Srpska in 2007, the pace slowed and only ten smaller enterprises and one strategic enterprise were privatised between April 2008 and May 2009 in this entity. So far, around 69% of the initial stock of state-owned capital intended for privatisation has been sold, one percentage point up compared to the previous year. The privatisation process in the Federation continues to proceed very slowly as the privatisation strategy of the government has still not been fully adopted. The sale of the aluminium company Aluminij d.d. Mostar, one of the largest enterprises in the country and a key source of export revenue, remains blocked because of the inability of the Federation government and the winning bidder to agree on a long-term electricity price contract. Also the Federation's two telecom companies still await their privatisation. *Overall*, the privatisation process did not advance.

Market entry and exit

Bosnia and Herzegovina has undertaken some limited reforms in order to improve the business environment. Obtaining a construction permit was simplified by facilitating the registration of new buildings in the land and property registries, reducing the average time to obtain a permit from 296 to 255 days. Transferring property also became more efficient thanks to the computerisation of the land registry. Despite some improvements in court registration the average time to start a business remained at 60 days. A new Law on Business Companies came into effect in Republika Srpska on 1 July 2009, simplifying the business start-up process, whereby certain inspections are now conducted after the business has started its operations. Concerning the closure of businesses, professional requirements for trustees were tightened, reducing the time needed in bankruptcy procedures. The "Legislative Guillotine" project to reduce administrative burdens is completed in Republika Srpska. In the Federation, it was launched in mid-2009. Businesses continue to suffer from political instability, the high tax burden, and slow contract enforcement and business registration procedures. *Overall,* some limited improvements in the business environment can be recorded, but reforms are not sufficient to substantially foster private sector developments.

The legal system

The poor quality of public services and prevalent corruption negatively affect the business climate and the attractiveness of Bosnia and Herzegovina for investors. 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 backlog of cases remains a major problem for judiciary. Various activities aimed at introducing systemic solutions for reducing delays in courts are underway, and a database has been created at the Sarajevo municipal court, where the vast majority of the backlog exists. Almost all courts in the country have now been connected to a nation-wide area network and the new Case Management System has been introduced. *Overall,* the operation of the judicial system has slightly improved; however, the existing backlog of unsolved cases, unreliable contract enforcement and slow processing times are hampering the business environment. The informal sector remains an important challenge, as it reduces the tax base and the efficiency of economic policies.

Financial sector development

Tensions on the global financial markets spilled over to the country and resulted in a "mini bank-run" in October when some €420 million of deposits (some 6.4% of the stock of deposits) were withdrawn. Foreign parent banks injected liquidity to their local subsidiaries and the Central Bank of Bosnia and Herzegovina reacted firmly and adequately so that the situation stabilised quickly. The limit on guaranteed bank deposits was almost tripled in a first step to around € 10,000 in early 2009. In the context of the IMF programme, the six EU parent banks that have subsidiaries in Bosnia and Herzegovina have committed to keep the level of their exposures to the country at least at the level of 31 December 2008.

Despite the repercussions of the global financial crisis on Bosnia and Herzegovina, the financial sector remained sound and well-capitalised and its liquidity position was not seriously undermined. The sector is dominated by banks which are based on a conservative business model. The share of claims to the private sector in relation to GDP remained relatively constant between 2008 and early 2009 at about 54%. 30 banks operate in the country, one less than in the previous year, of which 21 are in foreign ownership, seven in domestic private ownership and two are majority state-owned. The capital adequacy ratio stood at 16.3%, around one percentage point lower than in the previous year, but significantly higher than the legal minimum of 12%, which itself is significantly higher than the 8% required in the Basel II accord. The share of non-performing loans to total loans increased from 3.1% at end-2008 to 4% at the end of the first half 2009. The return on average equity halved in 2008 to 4.4% and decreased further to 1.3% at the end of the first half 2009, the return on average assets declined to 0.4% and further to 0.1%. Liquidity indicators deteriorated with the rate of liquid to total assets falling from 32.2% at mid-2008 to 28.5% a year later, and liquid assets to short-term financial liabilities from 53.5% to 49.5%. However, the liquidity situation of banks remained overall favourable. Financial market supervision remains mostly in the competence of the entities. In early 2009, Republika Srpska established a system to improve coordination between its own supervisory agencies. The analytical capacity of the Central Bank was further strengthened and it carried out stress tests for the banking sector in spring 2009. *Overall*, the expansion of financial intermediation has slowed down and the banks' profitability has suffered, but the financial sector has weathered well the impact of the global crisis and the stability of the financial system remains satisfactory.

Credit growth has come down significantly from the excessive annual rates of between 25% and 30% recorded until July 2008. Since September 2008 the stock of loans has been virtually unchanged. Restrictions came from both the demand and supply side. Deposits decreased by 9.8% from their peak in September 2008 until June 2009, and slightly picked up after that. As a consequence, the loans to deposit ratio increased from 110% in September to 119% in July. After it had followed a downward trend over the period 2004-2007, the spread between average loan and deposit interest rates of commercial banks increased and amounted to 7.81 percentage points at the end of the first quarter 2009. The widening of the spread was mainly caused by rising interest rates on loans, reflecting the higher uncertainty and risk faced by the financial sector. *Overall*, the difficult economic environment has caused market agents to become more risk-averse, but the fears of a massive bank-run and major liquidity problems emerging in autumn 2008 did not materialise.

After their major correction throughout 2007 and 2008, stock market indices continued to decline in the first quarter 2009, but afterwards picked up again. The main index of the Sarajevo Stock Exchange lost 12.8% in 2009 until mid-September; that of the Banja Luka Stock Exchange fell by 3.3%. Monthly average turnover at Sarajevo plummeted by 60% in the first half 2009 compared to 2008; at Banja Luka the drop was 45%. The combined market capitalisation declined to below 50% of GDP from rates at around 100% in 2008. The insurance sector remained small and relatively weak. Its growth lost pace in the first half of 2009 when it decelerated to 3.3% in the Federation and 2.6% in Republika Srpska (annual growth of premiums). Non-life insurance dominates the market. There are 24 insurance companies active in the country. *Overall,* financial intermediation by the non-banking sector remained shallow and stock markets experienced significant losses.

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

Existence of a functioning market economy

In the context of the crisis, external imbalances are decreasing, while fiscal imbalances are rising. The adjustment process is harsh and accompanied by rising unemployment. The slow pace of economic restructuring, especially in the Federation, prevailing obstacles to private sector development and the excessive influence of the public sector in the economy continue to undermine a more growth-oriented allocation of resources. *Overall*, the functioning of market mechanisms remained hampered by distortions, excessive state intervention and lack of competition. Progress towards creating a single economic space within the country – a key European Partnership priority – has been limited.

Human and physical capital

In general, information on the endowment of human capital remains scarce. Enrolment rates in higher education are slightly increasing. A curriculum for a nine-year education in all schools is to be implemented as of the school year 2009-2010. However, the proper implementation of framework laws for higher, pre-school and vocational education has not been ensured. Participation in the labour market is poor. *Overall,* structural rigidities and the weak performance of the education system continue to contribute to the skills mismatch hampering the proper functioning of the labour market.

The level of investment decreased slightly in 2008 to 24.4% of GDP, down from 25% in 2007. Some projects of upgrading road and railway infrastructure are ongoing. Foreign direct investments (FDI) accounted for 5.5% of GDP in 2008, declining sharply (by 55%) compared to 2007, mainly as a result of the high base due to major privatisation deals implemented in 2007. 46% of FDI were directed towards industrial production and 21% to transport and communications. In the first half of 2009, FDI shrank by 32% year-on-year as a result of worsened investors' sentiments in the context of the global economic crisis. *Overall,* the pace of upgrading of physical infrastructure slowed down.

Sectoral and enterprise structure

The restructuring and liquidation of socially-owned enterprises (SOEs) has made only slow progress. In the communication sector, few new entrants have become operational since liberalisation and only one new licence for fixed telephony services has been granted. So far two licences have been issued to internet service providers, two to network operators and three for Universal Mobile Telecommunications Services (UMTS). New rules on the compensation for licences of mobile telecommunications operators have been adopted. The utility sector remains exempted from privatisation. In May, the government of the Federation approved the merger of the country's biggest power utility company with seven local coal mining firms, but the deal is yet to be completed. Shortcomings in administration, technology and metering continue to hinder the development of the electricity market. Consumers have little incentive to change suppliers due to persisting differences between regulated and market prices. *Overall,* little progress was achieved in the liberalisation of network industries.

There were no major shifts in the sectoral structure of the economy in 2008. Services accounted for 54% of GDP, industry for 23% and agriculture for 7%. The contribution of public administration, education and health to gross value added in the economy remains fairly large at 18%. Small and medium-sized enterprises (SMEs) further consolidated their contribution to employment and economic growth and the first countrywide SME strategy has been adopted by the Council of Ministers. *Overall*, there have been no major changes in the structure of the economy.

State influence on competitiveness

Limited progress has been made in reducing state influence in the economy. Legislation to ensure the transparent monitoring of state aid has not been adopted and the establishment of an operationally independent, public state aid authority – as required by the Interim Agreement to the SAA – is pending. In 2008, direct budget subsidies to industry and agriculture slightly declined to a consolidated 1.5% of GDP from 1.6% in 2007. They are still mainly allocated to loss-making SOEs in an ad-hoc and non-transparent manner. *Overall,* state intervention in the economy is still high and initiatives to improve transparency are blocked in the complex decision-making procedures of the country.

Economic integration with the EU

Bosnia and Herzegovina is an open economy with total trade equivalent to around 94% of GDP in 2008 (93% in 2007). The country has constantly gained market shares in the EU during the past decade, not the least benefitting from a relatively stable CPI-based real effective exchange rate (REER) over that period. However, due to the high wage increases above productivity gains of recent years, both in the public and private sector, Bosnia and Herzegovina has lost competitiveness since 2007, as signalled by an increasing unit-labour-cost-based REER. The EU continues to be the largest trading partner with shares of around 55% of total exports and 49% of total imports in the first half of 2009. While the share of exports to the EU has slightly decreased, the share of imports has slightly increased. The other main trading partners remain the countries of the CEFTA region, accounting for 36% of exports and 26% of imports in the first half of 2009. The share of FDI inflows from the EU to total FDI inflows increased in 2008 as compared to 2007, when it was exceptionally low due to the major privatisations in Republika Srpska with non-EU buyers. *Overall,* the level of integration of trade and investment with the EU remained fairly high.

5.3. CONCLUSION

The economy of Bosnia and Herzegovina slowed down significantly in the fourth quarter of 2008 when the global crisis began to impact on the real economy. This trend continued in 2009, pushing the country into a recession. Unemployment remained at very high levels. The quality of public finances further deteriorated, characterised mainly by a dramatic increase in current expenditure. The country called for an IMF programme and a three-year stand-by arrangement was negotiated. Despite some progress in state-wide coordination of economic policy, the commitment to structural reforms remained uneven across the country.

As regards the economic criteria, Bosnia and Herzegovina has made little further progress towards 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.

Financial and monetary stability was preserved, as the central bank reacted appropriately to repercussions from the international financial crisis. The currency board arrangement continued to enjoy a very high degree of credibility. In line with international price developments, inflation rates have come down significantly. External imbalances have decreased, mainly driven by a rapidly adjusting trade balance. While the expansion of financial intermediation has slowed down, the banking sector has so far weathered well the impact of the global crisis. Some limited improvements in the business environment can be recorded, especially in the areas of construction permits, transfer of property, business registration, and market exit.

However, the quality and sustainability of public finances have further deteriorated. Current expenditures, especially on wages and social benefits, increased dramatically in 2008, and the share of general government in GDP remained high. Restructuring of public enterprises, the liberalisation of network industries and the privatisation have not proceeded further. The weak productive capacity and structural rigidities – high social contribution rates, distorted wage-setting mechanisms, high and poorly targeted social transfers and low labour mobility – continue to hamper job creation and the functioning of the labour market. Unemployment continues to be very high and the informal sector remains an important challenge. The business environment is still affected by administrative inefficiencies. Lower FDI and public investment slowed down the upgrading of infrastructures.

6. MONTENEGRO

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.

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Montenegro submitted its third Economic and Fiscal Programme (EFP), covering the period 2009-2011, by the end of January 2009. However, its assumptions became very quickly outdated due to the crisis. Yet, the fiscal strategy of the government continued to focus on keeping the budget deficits within 3% of GDP in both 2009 and 2010 despite the negative impact of the crisis and the cost of the measures adopted to mitigate its effects. Meanwhile, the government coalition partners overcame some of the previous discrepancies of views on economic policy. *Overall*, the domestic consensus on economic policy essentials has been maintained.

Macroeconomic stability

The economy continued to grow strongly at around 8% in real terms in 2008 driven by strong demand and, on the supply side, by construction and services. However, at the end of 2008 industrial output contracted on the poor results of manufacturing, and the metal industry in particular. This sector suffered from decline in external demand in the context of the international crisis and the subsequent collapse of commodity prices. In the first half of 2009 the economy contracted by 3.5%, as the negative effects of the crisis extended to several key sectors (i.e. basic metals, financial services, and construction). Industrial production contracted on average by 20% year-on-year in the first six months of 2009, as manufacturing output went down by 33%. Only three manufacturing industries (chemicals, foodstuffs and printing) and the utility sector expanded in the first half of the year compared with the previous one. On the other hand, after a bad spring the tourism industry recovered during the summer. Yet, as a consequence of the robust economic growth witnessed during most of 2008, Montenegro's per capita income, measured in purchasing power standards (PPS), rose to 46% of the EU27 average, compared with 41% a year earlier. *Overall*, after the high growth in 2008, the economy contracted in 2009 mainly due to the impact of the global crisis on the real economy.

In 2008, the current account deficit remained very large at 29% of GDP, despite the strong cutback in merchandise imports (45% year-on-year) in the last quarter of the year due to the sharp deceleration of the banks' lending activity. The surplus of the balance of services was on a declining trend. The factor income balance deteriorated in 2008, as compensation paid to the increasing number of foreign workers outpaced incomes from Montenegrins working abroad. The cool-down of the real estate market in 2008 resulted in a decline of FDI inflows by 17.4% year-on-year. Yet, the sizeable outflows associated to this market also decreased, which contributed to sustain net FDI levels at 17% of GDP. Foreign loans increasingly covered the financing gap of the current account deficit. The moderation of both domestic demand and imports related to foreign investments continued during the first half of 2009, resulting in a significant narrowing of the trade deficit by 36.6% year-on-year and a moderate contraction of the current account deficit to 22% of GDP (annualised). The faster decrease of FDI outflows by 53.2% over the year offset the decline in inflows (16.6%), so that on a net basis FDI still expanded to 16% of GDP, covering 80% of the current account deficit. *Overall*, as a consequence of the crisis, the large current account deficit declined until June 2009, while net FDI remained resilient.

Table 6.1:
Montenegro - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	4.4	4.2	8.6	10.7	8.1	-3.5
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Unemployment	%	22.3	18.5	14.7	11.9	10.7	10.3
Employment	Ann. % ch	28.3	0.6	4.5	3.7	6.3	5.3
Wages	Ann. % ch	11.7	8.0	15.6	14.2	22.8	10.1
Current account balance	% of GDP	-7.2	-8.5	-24.7	-29.4	-29.0	-22.0
Direct investment (FDI, net)	% of GDP	3.0	21.0	21.7	18.7	17.0	16.0
CPI	Ann. % ch	2.2	2.4	3.0	4.3	7.4	2.1
Interest rate (3 months)	% p.a.	10.58	1.20	1.21	:	:	4.06
Stock markets	Index	1,758	5,670	14,406	36,159	19,947	10,921
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
General government balance	% of GDP	-2.6	-2.3	2.7	6.4	0.5	0.1
General government debt	% of GDP	44.5	38.6	32.6	26.3	26.8	28.5

Sources: Thomson Reuters/Ecowin

The labour force survey (LFS, according to the ILO definition) revealed that the unemployment rate declined by 3 percentage points to 16.8% during 2008. More recent data from the Employment Agency shows that the official unemployment rates for 2009 also continued contracting until end-August. Meanwhile employment continued growing during 2009 by some 5% year-on-year. The unbalanced regional distribution of the workforce and its limited mobility remain a rigidity factor, favouring continued inflows of foreign workers. Yet, the government relies on the significant share of temporary non-resident workers to cushion imbalances on the local labour market. *Overall*, labour market indicators improved on favourable seasonal effects, despite diminishing economic activity.

In 2008 macroeconomic stability was also challenged by high prices. Yet, after peaking in August 2008 close to 10%, the average annual inflation declined to 7.4% by the end of the year. The consumer price index further slowed down to 2.1% year-on-year in July 2009 as housing and transport prices exerted a downward pressure. With the euro as sole legal tender([1]) the room for autonomous monetary policy remained limited. The Central Bank of Montenegro (CBCG) continued to use prudential requirements, in particular reserve requirements, as intervention tools. The CBCG has been very active trying to preserve the stability of the local financial system. In autumn 2008 the growth of broad money supply([2]) turned negative due to serious withdrawals of bank deposits. The CBCG intervened by urgently adopting a set of measures for protecting the banking system, consisting in a full guarantee for deposits and the possibility of government credit support for eventual liquidity shortfalls of banks. *Overall*, inflation has been decelerating as the economy cooled down.

The lending activity of commercial banks expanded by 23% year-on-year in 2008, as compared with 165% a year before. The moderation was initially the consequence of the Central Bank measures to bring the lending boom down to sustainable levels. The credit portfolio reached 83% of GDP in 2008 up from 80% a year earlier, while bank deposits declined by 6.7% year-on-year. During the first half

([1]) Montenegro unilaterally uses the euro as legal tender, without participating in the euro area. In October 2007 the Council adopted a declaration on the *de facto* use of the euro in Montenegro which is due to exceptional circumstances.
([2]) The broad measure of money (M21) aggregate consists of deposits of banks with the Central Bank and demand and term deposits with banks and the Central Bank, in euros and other currencies, including deposits of the central government.

of 2009 the liquidity shortage triggered by the withdrawal of deposits constrained the lending capacity of the banking sector. The contraction of deposits reached 11.7%, while credit growth dropped by 5.9% since the start of the year. *Overall*, the liquidity of the banking system was challenged by the problems in the second largest lender and the effects of the global financial crisis.

In 2008 the budget execution yielded a surplus of 0.5% of GDP. Consolidated public expenditures increased significantly, reaching 44% of GDP from 41% of GDP in 2007, boosted by rising transfers to social security institutions and to households. This expansionary increase in spending commitments put additional pressure on fiscal policy as of early 2009, when the local repercussions of the crisis resulted in lower fiscal revenues than planned. Nonetheless, the authorities reacted promptly by curtailing spending and still maintaining a budget surplus of 0.4% of GDP in the first half of 2009. The government revised the 2009 budget in July, notably by reducing capital investments, expenditures in goods and services and planning wage cuts in public administration, in order to maintain the deficit at 2.6% of GDP. Loans from foreign private banks were subscribed and a minority stake in the power utility (EPCG) was sold to a foreign partner. However, other fiscal risks, in particular the contingent liabilities linked to the restructuring packages for the metal industries and the liquidity problems in the banking sector. *Overall*, public finances have come under increased pressure in 2009, but the authorities managed to limit the deficit by curtailing spending, borrowing and selling assets.

In 2008 the public debt remained broadly unchanged in GDP terms at 26.8%. Public debt further increased in the first half of 2009 to 28.4% of projected annual GDP. Public domestic debt increased by 9% since the beginning of the year, while the public external debt grew faster, by 15% since end-2008, mostly due to investments in infrastructure co-financed by international financial institutions. During the third quarter of 2009, the government subscribed two loans worth 3.4% of GDP from foreign private banks for financing the state budget, bringing public debt above 30% of GDP at the end of the year. *Overall*, debt obligations are rising due to infrastructure spending and loans to finance the emerging budget deficit.

Macroeconomic policy has been driven to a large extent by the financial crisis. It focused on implementing a more prudent fiscal policy and accelerating structural reforms in several sectors. For instance, developing a more market-oriented approach to highway construction by involving the private sector through Public-Private Partnerships (PPPs), reducing the fiscal burden on labour to increase competitiveness, or developing the legislative framework for the financial system with the adoption of legislation based on EC Directives. The Central Bank has also contributed to macroeconomic stability by timely adapting monetary policy to fast-evolving circumstances. In 2008 the CBCG introduced a restrictive policy to reduce the exposure of the economy to the surge of a credit bubble. In 2009 it reversed its path, easing reserve requirements to release more liquidity into the financial system. *Overall*, structural reform policies combined with a timely adaptation of the fiscal and monetary policy to the international crisis impact, are contributing to recovery.

Interplay of market forces

The share of the private sector in the economy is very large as the public sector is mostly reduced to network industries (utilities and transport). Moreover, the influence of the public sector in price dynamics is practically limited to the energy sector. The energy regulator establishes electricity prices in relation to production cost thresholds. In June 2009, the Administrative Court annulled the energy regulator's decision to increase electricity prices. As a result, some €20 million from the overhead prices are being returned to consumers gradually by decreasing prices for electricity until the debt is settled. The privatisation process also suffered from the global crisis as some successful bidders failed to conclude a sales agreement. This was notably the case with the auctions of the tobacco retailer Duvankomerc, and the publisher Pobjeda. A few publicly owned companies failed repeatedly to attract interest from investors, such as the appliances factory Obod or the insurance company Lovćen.

In these cases, new privatisation methods are proposed and companies are being slated for sale again. Further progress has been recorded in the privatisation of key energy and transport systems. The government sold a minority stake in the power utility (EPCG), providing the possibility for the new partner to acquire majority control of the company after five years. The railway transportation company and the port of Bar have already established their freight units as completely independent companies, preparing their privatisation through concession deals. However, restructuring of the aluminium and steel plants remains a considerable challenge. *Overall*, the privatisation process is quite advanced and state intervention in the economy has remained limited except for temporary rescue operations in strategic sectors such as basic metals and banks.

Market entry and exit

The Council for the elimination of business barriers, established in mid 2008, continued its activity in 2009. Achievements in the relevant period included the simplification of administrative procedure for obtaining construction permits and reviewing technical documentation and enhancement of transparency through the relevant authorities' obligation of publishing related documentation on their website. The operation of new trade outlets does not require any longer municipal license but a simple announcement of intent for record purposes. In addition, the authorities have also established a website for gathering online requests from entrepreneurs to remove further barriers. However, electronic signature legislation still needs to be implemented in order to benefit from the full potential of online business and administrative transactions. Market exit procedures have been reduced to six months on average. In the first half of 2009, in spite of the crisis, registration of new enterprises continued at an average of 212 new limited liability companies per month compared with 284 during 2008. During the first five months of 2009 the Commercial Court registered 134 bankruptcy procedures, a similar number to that recorded during the same period a year before (138). The backlog of ongoing cases decreased to 139, practically converging with the number of newly opened files. Additionally, 284 companies applied for voluntary liquidation under the Law on Insolvency, and were subsequently removed from the registry of the Commercial Court. *Overall*, market entry has improved and exit procedures have been further streamlined.

Legal system

Three key pieces of legislation regulating property rights were adopted in 2009. The Concession and the State Property Laws introduced more comprehensible concession rights on public properties and resources, with the possibility of extension of such contracts up to 90 years. The Property Relations Law provides the same treatment to foreign citizens as to nationals for acquiring movable and immovable property, although some limitations still remain for foreigners purchasing agricultural land, for which the new law provides long-term leasing as an alternative. Recourse to the judicial system increased as previous reluctance to resolve commercial disputes through official circuits is fading away, also due to the negative effects of the crisis. During the first half of 2009 the Commercial Court received 5,200 cases (compared with 1,279 a year before). However, 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. *Overall*, the new property laws improved legal certainty facilitating foreign investors' engagement in large projects. However, the fight against corruption and tackling the large informal economy remain major challenges.

Financial sector development

The size of the banking sector in terms of assets stabilised at 99% of GDP by the end of 2008, compared with 106% a year earlier. However, banks assets further contracted to 88.7% of GDP by end-June 2009 as deposit withdrawals and negative lending growth persisted. The sector remained highly concentrated, with three banks holding 63.9% of the banking sector's assets and 58.8% of total deposits. Excessive risk taking by Prva Banka -the second largest bank- without due concern for prudent banking practices, resulted in stability risks for the whole sector. Faced also with the effects of an international crisis threatening the domestic market, the Central Bank together with the government adopted several measures for the protection of the banking system. A full guarantee for all deposits, and the possibility of government credit support for liquidity shortfalls or for recapitalisation were granted. In an attempt to improve positions of both lenders and debtors and to create more space for bank lending activities, the CBCG also introduced additional measures to create more favourable conditions for loans restructuring and further reduced the rate of mandatory reserves on existing deposits to 10%, with no reserve requirements for new deposits. The government also intervened by providing a credit support of € 44 million (about 1.3% of 2008 GDP) to Prva Banka in exchange for this bank's shares placed as collateral. The bank has meanwhile managed to repay 75% of the loan. The withdrawal of deposits set off in October 2008, occurring at a rate of 18% until February 2009, moderated to an average monthly contraction of 0.2% in the second quarter of 2009. As a result, during the first half of 2009 the banking system lost deposits for some 5.7% of GDP, most of it from the two biggest banks. End-June 2009, the average capital adequacy ratio came down to 11.9%, close to the stipulated 10% minimum level, while the ratio of non-performing loans([1]) climbed to 8.9%, compared with 3.9% a year before. In June 2009 the average weighted effective lending interest rate peaked at 9.38%, while the weighted average deposit effective interest rates recorded 3.80%, down from 9.40% and 4.10% respectively in December 2008. *Overall*, the stability of the financial system was maintained under very difficult circumstances.

The domestic insurance market further expanded by a more modest 18% year-on-year in 2008, following a 28.7% expansion of billed premiums a year before. End 2008 there were 11 companies active in the sector, after several new firms entered the market. The sector remains highly concentrated, with one company holding a 61% market share. The industry accounts for some 3% of GDP and is primarily made up of compulsory insurance. Its life insurance segment is developing fast from a very low base and accounted in 2008 for some 12% of total premiums (compared with 4.5% a year before). The leasing market continued its rapid expansion in 2008, increasing contract value by 42.2% year-on-year, representing 4.9% of GDP (compared to 4.1% a year before). The majority of leasing contracts relate to real estate and vehicle purchases. The two stock exchanges showed signs of recovery in May 2009 as the markets were positively influenced by the sale of a minority stake in the power utility EPCG. In May, after more than one year of continuous deterioration, the aggregate capitalisation rose to 147% of GDP, from 116% in the previous month. *Overall*, while the non-banking financial sector continued expanding, capital markets went through a severe correction.

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

Existence of a functioning market economy

Quick responses to a fast-changing and difficult global economic environment prevented a deep deterioration of macroeconomic stability, as employment was preserved, prices moderated and the public deficit was contained. Macroeconomic stability was seriously challenged by an expansionary

([1]) Considering the Central Bank of Montenegro's stricter classification of past-due loans as any loan that is past due for more than 61 days, compared with the Basel II classification of after 90 days.

fiscal stance in 2008, followed by liquidity problems in the banking sector, and current contingent liabilities in the metal sector. Apart from direct support to metal smelters and one bank, the authorities' rescue plans focused on accelerating structural reforms and preserving the stability of the financial system. To this end, the government provided credit guarantees to international banks for extending loans to domestic lenders which freely decided on the final allocation of credit. *Overall*, the functioning of market mechanisms was challenged by the magnitude of adjustments taking place in the external accounts and the financial sector.

Human and physical capital

In the context of still persistent labour demand, several educational reforms were implemented to align the supply side with market requirements, not least the Law on National Vocational Qualifications, and the strategies for introducing didactic software in education and for establishing the qualification framework. For young managers having already graduated, the Agency for Employment (ZZZ) together with the Directorate for Small and Medium-Sized Enterprises (SMEDA) implemented practical training programmes. The Agency continued its activities with academic institutions, providing professional guidance, but also adopting programmes for the integration of minorities into the workforce as well as to improve work participation rates, especially in the poorer northern region. *Overall*, the skills mismatch remains an important issue. In some labour intensive sectors the country needs to resort to foreign workers to sustain economic growth.

Gross fixed capital formation (GFCF) as a share of GDP reached 24% in 2007. Estimates for 2008 suggest a ratio of 30% of GDP. Almost 40% of FDI invested in 2008 went into real estate, 30% in domestic companies and banks and a similar amount in intercompany debt (namely foreign banks towards local subsidiaries). Public capital spending increased in 2008, reaching 9.3% of GDP, compared with 6.7% a year earlier. However, during the first half of 2009, further moderation in credit expansion and budget spending cuts reduced capital formation. *Overall*, worsening economic conditions did not stop restructuring in energy and transport as well as the launch of major concessions for private investments in tourism and highways.

Sectoral and enterprise structure

The crisis exacerbated the weakness of the main industries of the country –basic metals production– already hampered by excessively high production costs. To restructure and address the structural problems of the aluminium smelter, and the more cyclical ones of the steel mill, the government provided credit guarantees and a redundancy programme to proceed with technological upgrades and labour cuts. In the energy sector, after the separation of the transmission unit from the power company (EPCG), establishing tariffs for the use of the network and the adoption of secondary legislation, all necessary preconditions were formally met for the development of competition and establishment of the electricity market. Meanwhile, the government sold in July a minority stake in the utility, retaining a 55% share. The new partner may later acquire majority control in EPCG subject to successful implementation of the investment programme. The railway transportation company and the port of Bar separated their freight units, thus preparing the ground for their privatisation also with a view to securing the necessary capital for their modernisation. The national air carrier, Montenegro Airlines, implemented the first stage of its restructuring by transformation into a shareholder company. *Overall*, a significant restructuring of strategic enterprises and sectors is underway.

The structure of the economy continued shifting towards services. More than 70% of total employment during 2008 was recorded in services. Public administration employees([1]) in total services decreased by 2%, while the private sector witnessed an increase of 4% year-on-year, driven by large increases in the number of hotel and restaurant workers, but also transport and financial

([1]) Including: public administration, social insurance, education, health and social workers.

activities. Yet the largest share of tertiary labour remains wholesale and retail trade (20% of total labour). The industrial sector represented 22% of the total workforce, but is on a declining trend. The participation of workers in agriculture, forestry and fishing represented some 8% of total employment. *Overall*, most of the advertised employment vacancies (63%) concerned jobs in tourism, construction and trade sectors, confirming that the economic shift to these activities continues.

Small and medium-sized enterprises (SMEs) are proving their resilience as the number of bankruptcies in 2009 remained at the same level as a year before although the number of unpaid invoices reported by the Central Bank payment system has been rising. The SME sector represents some 60% of GDP and employs 67% of the total workforce. Most companies (77%) have less than 10 employees and deal largely in retail and repair services. They still face a number of persistent difficulties, such as revolving existing loans, obtaining municipal permits or the absence of spatial planning documents. *Overall*, SMEs went through very difficult conditions, confronting increasing payment arrears, diminishing demand and stricter conditions to obtain bank loans.

State influence on competitiveness

Government intervention in the economy expanded with the adoption of several initiatives in support of those sectors most affected by the crisis, namely banking and metallurgy. Since the start of the crisis until mid-2009 state guarantees amounted to 9% of GDP, of which 42% were for loans to the aluminium complex KAP and the bauxite mine RBN (partially renationalised), 47% to banks and 8% to the steel mill Niksic. The measures approved to protect banks depositors benefited both local and foreign lenders operating in the country. The authorities also adopted a programme reducing electricity prices for the most vulnerable categories of the population, as well as for SMEs. In addition, the major industrial companies (the steel mill and the aluminium factory) saw their temporary subsidies for the purchase of electricity extended on condition of achieving major restructuring. *Overall*, increased state intervention occurred as a reaction to the unfolding crisis.

Economic integration with the EU

As a consequence of the crisis the annualised level of openness of the economy decreased in the first half of 2009 to 50.6% of GDP, from 83% a year earlier. The main foreign destination for domestic products remains the EU, which accounts for 57.8% of the total (down from 64.6% in 2008), followed by CEFTA countries (40.2%, up from 33.4% in 2008). The reversed trend was confirmed for imports, which mostly originate from neighbouring CEFTA countries (53.3%, up from 50% a year before), followed by the EU (38.2%, down from 41.4% in 2008). *Overall*, trade openness remained high, although the severe contraction of the metal industry brought down the main export of the country, traditionally oriented to the EU market.

6.3. CONCLUSION

The economy of Montenegro decelerated markedly in 2009. As a result, public finances came under severe pressure and public debt further expanded. However, the economy did not slip into a deep recession, and the external financing risks did not fully materialise. Despite the economic crisis, the government pushed forward a series of structural reforms. Enhancing the rule of law and upgrading infrastructures remain key challenges for economic development.

As regards the economic criteria, the country has made further progress towards establishing a functioning market economy. In order to enable it to cope in the medium term with competitive pressure and market forces within the Union, it should continue comprehensive reforms to reduce structural weaknesses.

External imbalances and inflation were reduced as a result of the deceleration of economic activity. Labour market indicators continued to improve, despite the slow down in growth. Foreign parent banks sustained financing to their local subsidiaries, thus supporting the stability of the financial system in the absence of a lender of last resort. The budget deficit was reduced by curtailing spending and by receipts from the privatisation of large network systems. Public debt grew, but remained at moderate levels. Legislation to enhance certainty about property rights has been adopted. Legislative simplification proceeded in view of removing business barriers and the backlog in bankruptcy cases decreased. The state's role in the economy increased, in response to the unfolding crisis, but it was limited to providing loans and loan guarantees for key sectors of the economy.

However, conditions for Montenegro's manufacturing sector deteriorated sharply, as it was hit by contracting external demand and by falling international prices for steel and aluminium. Restructuring of the aluminium and steel plants remain a considerable challenge. The financial system suffered a severe liquidity crunch at the end of 2008 and early 2009 as a result of large deposits withdrawals. Interest rates remained high despite liquidity injections in the banking system. Public finances came under severe pressure while government guarantees on loans piled up. The capital markets went through a severe correction, suffering substantial losses. A mismatch persists between labour supply and demand, forcing employers to resort to foreign workers even though unemployment is high. The informal sector remains an important challenge.

7. SERBIA

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

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In January 2009, the government submitted to the European Commission an Economic and Fiscal Programme (EFP), covering the years 2009-2011. The programme builds on the budget memorandum of May and the December 2008 update thereof and presented a generally coherent and ambitious macroeconomic and fiscal framework together with an ambitious agenda for structural reforms. In the light of the deteriorating economic situation in autumn 2008 and beginning of 2009, the EFP rapidly became outdated and it retains only limited relevance as a core document for economic policy making. In June 2009, the Serbian government adopted a new budget memorandum, in the context of a budget revision.

In December 2008, the Serbian authorities requested a Stand-by Arrangement (SBA) for over €420 million from the International Monetary Fund (IMF), which was approved in January 2009. As the impact of the global economic crisis turned into a domestic fiscal crisis, in April 2009, the Serbian government agreed with the IMF on a revision of the programme assumptions, an increase of the available loan to €2.9 billion and an extension of the agreement to April 2011. A first tranche of this assistance, worth €788 million, was drawn in May 2009. A set of fiscal measures has been implemented in the context of the revised IMF programme, with the objective to ease the fiscal crisis. However, the underlying structural weaknesses of Serbian public finances, in particular as regards the unreformed welfare state, have not been addressed in depth. *Overall*, consensus on the fundamentals of a market economy has been maintained, but the government lacks a medium-term reform strategy.

Macroeconomic stability

In 2008, GDP growth decelerated to 5.4% compared to 6.9% in 2007 as the country started being affected by the global economic crisis. Growth in the last quarter of 2008 declined to 2.8% year-on-year as compared to an average growth rate of 6.5% in the previous three quarters. During the first quarter of 2009, GDP declined by 3.5% year-on-year. In 2008, industrial output was 1% higher than in the previous year, mainly due to good results during the first half of the year.

The declining trend that started in the second quarter of the year accelerated sharply towards the end of 2008 and further intensified in early 2009. Industrial production declined by 17.4% in the first half of 2009 compared to the same period of the previous year. In 2008, export growth slowed to 15.5%, compared to 26.1% a year earlier. During the first quarter of 2009, exports contracted by 23.8% year-on-year. As a result, growth projections for 2009 were revised downwards from an initial 6.5% to 3.5% and to -2% in March. Growth projections were further reduced to -6% mid-2009 on the back of the strongly deteriorating economic indicators during the first half of the year. In 2008, average per capita income in purchasing power standards rose to 37% of the EU-27 average, up from 33% in 2007. *Overall*, the Serbian economy was substantially affected by the global economic crisis and has been in recession during the first half of 2009.

Table 7.1:
Serbia - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	8.3	5.6	5.2	6.9	5.5	-4.1
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Unemployment	%	19.5	21.8	21.6	18.8	13.6	15.3
Employment	Ann. % ch	0.4	-6.7	-3.8	1.0	6.2	-5.1
Wages	Ann. % ch	23.7	24.1	24.4	22.1	17.9	11.3
Current account balance	% of GDP	-13.4	-8.3	-9.4	-14.9	-17.6	-7.5
Direct investment (FDI, net)	% of GDP	3.9	5.9	13.5	5.9	5.6	6.6
CPI	Ann. % ch	9.8	17.3	12.7	6.8	10.9	10.0
Interest rate (3 months)	% p.a.	21.16	17.54	13.48	6.44	5.34	15.81
Stock markets	Index	N.A.	1,737	2,186	4,096	2,604	1,040
Exchange rate RSD/EUR	Value	73.10	83.25	83.91	79.90	81.94	94.37
Nominal eff. exchange rate	Index	114.2	100.0	98.5	105.5	105.4	89.1
General government balance	% of GDP	0.9	0.9	-1.6	-2.0	-2.5	-1.0
General government debt	% of GDP	53.3	50.3	36.2	29.4	25.6	29.7

Sources: Thomson Reuters/Ecowin

The international financial crisis strongly impacted Serbia's economy and its financial sector. External imbalances rendered the Serbian economy vulnerable to possible disruptions in capital flows and the risks of a sudden stop or reversal of capital flows started growing. As this disruption occurred during the last quarter of 2008, the Serbian authorities approached international financial institutions to secure access to fresh loans. With the aim to inject liquidity in the financial sector, the authorities also adopted two packages in February and in May 2009, comprising loans at a preferential interest rates subsidised by the Government. The latter loans were aimed at addressing the needs of local companies faced with serious problems in financing their activities.

In 2008, the current account deficit widened to 17.6% of GDP from 15.6% a year earlier, driven by a growing deficit in the trade balance and a decline in current transfers. Strong domestic demand, fuelled by a relaxation of fiscal and wage policies, and a drop in exports of some of the major export items — notably steel — contributed to the deterioration in external accounts. Capital inflows remained substantial at 16% of GDP. However, they fell short of the financing needs. Foreign direct investment remained stable at €1.81 billion or 5.3% of GDP. Long-term borrowing by the corporate sector continued to grow by €2.5 billion albeit at a slower pace than in 2007. Short-term borrowing rose from almost zero to about € 500 million. Capital inflows practically stalled, however, towards the end of the year and in the first months of 2009. Foreign exchange reserves declined by €1.8 billion to €8.2 billion by the end of 2008. However, as the first tranche of the IMF loan was disbursed and inflows of remittances picked up in early 2009, foreign exchange reserves of the National Bank of Serbia (NBS) grew again to € 8.9 billion at end-May, reaching a comfortable 9 months worth of imports or 27% of GDP. External debt grew to € 21.7 billion or 70% of GDP at end-June 2009 from €18.6 billion or 58% of GDP in June 2008. *Overall*, the Serbian economy is going through a process of substantial external adjustment, as reflected in a rapidly contracting current account deficit, while foreign exchange reserves have been secured at a comfortable level. Consequentially, the level of external debt has been increasing.

In 2008, labour market conditions improved slightly. The employment rate rose to 53.3%, compared to 51.5% a year earlier, but then again fell to 50.8% in April 2009([1]). The registered unemployment

([1]) However, the drop in unemployment between 2007 and 2008 was mainly due to methodological changes.

rate fell to 14.8% compared to 18.3% in 2007. This rate also rose in April 2009 to 16.4%. Nominal wages grew by 17.9% year-on-year in 2008, compared to 27.9% a year earlier. However, real wage growth slowed to 3.9% year-on-year, substantially less than in 2007 when real wages grew by a strong 19.5% year-on-year. Nominal wages grew by 8.9% year-on-year in May 2009 and, as inflation remained relatively high during the first few months of the year, in real terms by 0.6% for the same period. *Overall*, despite strong economic growth rates in recent years, unemployment remains persistently high.

The monetary policy framework that had been introduced in September 2006 was adjusted in January 2009, when the National Bank of Serbia (NBS) switched from targeting core inflation to a target of consumer price inflation. For 2009, the annual consumer price index (CPI) inflation target band was announced at a band between 11% and 15% year-on-year. In January 2009, CPI inflation accelerated back to 10.4%, driven by increases in regulated prices, such as for oil derivatives, medications, communal services and fixed line telephone service, but thereafter declined again to 7.5% in June. At end-October 2008 the NBS increased its policy rate by 200 basis points to 17.75% to stem rising inflationary pressures but also to help support the local currency, which had come under growing pressure on the foreign exchange market in late 2008. In early 2009, the NBS reversed course and reduced its policy rate in several steps by 5.75 percentage points to 12.0% at end-July, in an attempt to boost dinar liquidity and support the collapsing domestic economy. *Overall*, inflation remained relatively high in Serbia, despite the economic recession, due to strong increases in administered prices and persistently high inflation expectations. The monetary policy framework of inflation targeting remained difficult to implement successfully**.**

As far as the foreign exchange rate policy is concerned, the NBS was forced to intervene in the inter-bank market in late 2008 and early 2009, following the strong and rapid depreciation of the dinar that started in October. In the last quarter of 2008, the dinar nominally depreciated against the euro by 15.7%. The Serbian currency kept losing value during October, November and early December when it reached 91.63 dinar against the euro when the NBS intervened. After a month of stabilisation, the dinar fell to an all-time low of 96.33 dinar against the euro, in spite of a total of €480 million in interventions in January and February. Since then, the exchange rate has stabilised between 92 and 95 dinar against the euro, and the NBS has abstained from intervening. *Overall*, the dinar has lost some 23% against the euro since September 2008, but has stabilised since February 2009.

The expansionary fiscal policy of 2007 and early 2008, further intensified in the second half of 2008 as election promises were being delivered. The consolidated fiscal deficit stood at 6.5% of GDP during the last quarter of the year. For the whole of 2008, the consolidated fiscal deficit rose to 2.4% of GDP from 1.9% a year earlier. The rise of current expenditure was particularly large due to labour costs and pensions, which together continued to account for 54% of total public spending. Among all expenditures, those for pensions saw the highest growth in 2008 (overall 35% increase in nominal terms). On the other hand, capital expenditures declined to 3.9% of GDP in 2008 compared to 4.9% a year earlier. On the revenue side, there was a decrease in real revenues from indirect taxes in the fourth quarter of 2008. Given this negative trend, the 2009 budget, adopted on 29 December 2009, was based on a growth assumption that was too optimistic, therefore rendering the revenue and expenditure projections for 2009 unrealistic. This was confirmed as budget revenues in January and February were well below projections. In view of the need to agree on a revised macroeconomic framework with the IMF, a revised budget was adopted on 29 April 2009, aimed at keeping the fiscal deficit at 3.0% of GDP. However, by end-June it was clear that the mid-year target of the IMF programme would not be met amid growing expenditures and declining revenues. The IMF programme had to be revised. The public deficit for 2009 is now predicted to be higher, at about 4.5% of GDP. Serbia and IMF agreed to postpone final discussions until end-October allowing Serbia to suggest further adjustments in view of the 2010 budget. *Overall*, fiscal policy remained expansionary in 2008, leaving Serbia particularly vulnerable to the fallout of the global economic crisis. As it became clear that public finances were deteriorating fast in early 2009, the Serbian authorities committed to budget adjustments that, in the context of the crisis, so far have turned out to be insufficient to stabilise public finances.

Expansionary fiscal policy and current account deficits made Serbia particularly vulnerable to the global crisis. The situation further deteriorated throughout 2008 and in early 2009 as the impact of the global economic crisis was increasingly being felt domestically. The fiscal reform measures agreed in the IMF programme appear to be insufficient to fully address adjustment needs over the short-term and further structural improvements of public finances will be needed in the medium-term. At the same time, structural reforms, in particular enterprise restructuring and privatisation, would contribute to cutting wasteful subsidies to unviable enterprises and to fostering the establishment of a competitive and dynamic private sector. A review of the social security policies and systems, in particular pension and health reform as well as the education system, with a view to ensuring medium-term sustainability of the systems and of public finances is still missing. This would also contribute to lowering labour costs and help increasing employment. *Overall*, further efforts are needed to address short-term fiscal adjustment needs and fully re-establish medium-term fiscal sustainability.

Interplay of market forces

The share of the private sector remains small at between 55% and 60% of total output. The private sector employs about 60% of the total number of employees.

The privatisation of socially-owned companies continued in 2008 and about 560 socially-owned companies were sold (15 tenders, 226 auctions and about 320 companies sold through the sale of state-owned stakes on the capital market). This brought revenues amounting to about €330 million. By the end of 2008, the total number of companies privatised through tenders or auctions since the beginning of the process in 2002 had risen to over 1,800 and has brought about €2.3 billion in privatisation revenues. The number of firms that still need to be sold declined substantially in 2008. *Overall*, progress in selling state-owned companies was hampered by reduced interest in acquiring such companies due to the global economic crisis.

According to earlier plans, four large state-owned companies (the electricity company EPS, Telekom, Belgrade airport and the pharmaceutical company Galenika) were to be offered for sale in the form of initial public offerings. This plan has been postponed for the time being. However, the government is still considering the possibility to offer Galenika and Telekom for sale in 2010 when market conditions related to the global crisis improve. On the other hand, the state oil company NIS was sold (a 51% majority stake for €400 million) as part of a wider framework agreement for supply of gas and oil with Russia. The agreement was finalised in December 2008 and the new owner Gazprom took over the company in February 2009. With regard to the long-standing issue of privatisation of national car producer Zastava, a joint venture agreement has been signed with Italian car manufacturer Fiat in early 2009. The question of privatisation of about 500 utilities at the level of local communities remains open. Their restructuring and reorganisation have not yet begun and the plan for their privatisation remains undefined. After the legislation on the free distribution of minority shares in six state-owned companies to all adult citizens was adopted in December 2007, no new developments took place in 2008 and early 2009 as shares have not been distributed yet. This is a reflection of the fact that 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 the development of competitive domestic production and burdens public finances. Finalising the process of privatisation or, when necessary, liquidation of socially- and state-owned enterprises is one of the key priorities of the European Partnership. *Overall*, some progress was made, as the privatisation of socially-owned companies has been almost finalised. However, state-owned companies remain mainly non-restructured, therefore, a competitive and dynamic private sector has not been established. The private sector has been further weakened by the ongoing liquidity crisis.

Market entry and exit

With regard to market entry and exit, some progress was made. In April 2009 the number of registered companies slightly increased reaching 106,000 compared to 100,000 of the previous year. At the same time, about 220,000 entrepreneurs were registered with the Serbian Business Registry Agency. The process of registration has been further simplified as registration with the tax authorities is no longer done separately. With regard to market exit, implementation of the 2005 Bankruptcy Law has continued and a draft of the new legislation on bankruptcy was finalised in March 2009. The number of pending cases was still very high at the end of 2008. Further efforts are needed to improve the business environment such as in the area of construction permits. *Overall*, although some progress was registered, excessive bureaucratic requirements and complex legislation continue to hamper the business environment.

Legal system

With regard to the legal system, some progress can be reported in a number of *acquis*-related areas. However, a number of reform-related laws have been held up and implementation of the existing laws is sometimes weak. The courts and administrative bodies sometimes lack the technical capacity and personnel to perform their activities properly and promptly, and corruption remains prevalent in many areas. This has led to inconsistent implementation and very lengthy procedures, which frequently exceed the deadlines set by law. *Overall*, weaknesses in the judiciary continued to limit legal predictability and to undermine trust in the legal system among economic operators, in particular as regards effective enforcement of property rights.

Financial sector development

The lending activity of banks increased by 35% in 2008. The share of total loans granted to enterprises and households stood at 61.5% and 35.5% respectively. Deposit activities of banks grew by 7% (after 44% during the previous year). The largest share of deposits was accounted for by the household sector (46%), followed by the enterprise sector (31%) and bank deposits (15%). Foreign currency deposits made up 69% of total deposits.

These deposits were particularly affected by the start of the crisis. In October 2008 over EUR 1 billion was withdrawn from local banks. However, fears related to banking sector stability turned out to be unfounded. Deposits stabilised quickly. The banking system has weathered the crisis well so far. The large share of FX or FX-indexed loans in the portfolios of Serbian banks remains a concern (about 69% of all loans) as it is a source of credit risk from un-hedged beneficiaries. Non-performing loans increased to 7.2% in June 2009 from 4.0% a year earlier. However, the risks have been tempered somewhat by the banking system's large share of liquid assets (23.6% as of February 2009) and substantial capital buffers (capital adequacy ratio of 21.9% at fourth quarter). Foreign banks agreed to maintain their exposure in Serbia unchanged at the level of end-2008. *Overall*, financial intermediation continued to grow, though at a slower rate than in the past and from a still relatively low level. Substantial balance-sheet risks for banks exist due to large share of foreign nominated loan.

The number of majority state-owned banks remained unchanged at 4 out of a total of 34. However, the National Bank and the Government of Serbia adopted a strategy to reduce state ownership in the banking sector. There are 20 banks that 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 46.2% of the total banking sector. *Overall*, competition between banks is well established and privatisation of the remaining state-owned banks has advanced slowly.

At end-December 2008, the share of total credits in default (non performing loans) in total outstanding debt stood at 4.7% (from 3.7% a year earlier). The foreign exchange risk ratio of banks stood at 8%.

The average capital adequacy ratio of the banking system stood at 21.9% (from 27.7% a year earlier) and, consequently, remained well above the required minimum of 12% of risk-weighted assets for each bank. The profitability of the banking sector deteriorated in the last quarter of 2008 and the return on equity fell to 9.3% from 12.7% in 2007. *Overall*, the banking sector remains profitable and generally sound. However, the high share of high-risk assets indicates substantial financial vulnerabilities.

The Belgrade stock exchange registered negative performance in 2008. Both indexes fell sharply: BELEX15 (of the 15 largest companies) by 75.6%, and BelexLine by 68.7%. This negative trend continued in the first four months of 2009, followed by a recovery in May. In February 2009, the government started to issue on a large scale T-bills with 3 and 6 months maturity, to help finance the growing deficits in the public budgets. The total amount outstanding was € 634 million by June 2009. At the end of 2008, there were 24 insurance companies operating in Serbia (from 20 a year earlier) with an increase in staff to 11,700 (+21%). 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. Privately owned insurance companies increased their previously noted prevalent share in non-life premiums from 59.1% in 2007 to 61% in 2008, as well as in total assets from 58.6% to 61.2%. In the five years from 2004 to 2008, the premium income more than doubled, at an annual growth rate of 16.5%. However, the insurance sector's share of capital in the total financial sector has decreased to 5.6%. *Overall*, progress continued in the development of the non-banking financial sector, but its size remains limited.

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

Existence of a functioning market economy

Sharply deteriorating macroeconomic stability towards the end of 2008, and in particular in early 2009, contributed to creating a less stable and less predictable climate for decision-making by economic operators. The functioning of market mechanisms remained hampered by distortions, legal uncertainty, heavy state involvement in the production of private goods and insufficient competition.

Human and physical capital

Little progress can be reported on the reform of the education system in relation to labour market demand. The gap between demand and supply of skilled employees continues to be an obstacle to increasing foreign direct investment and developing new branches of the economy. Therefore, companies are responding to the growing shortages by becoming more proactive in offering personal/professional development and training incentives to new recruits. Attitudes towards lifelong learning and mobility continued to change. Public education expenditure accounts for a relatively small 3.4% of GDP, well below average EU levels. *Overall*, the economy has been suffering from a shortage of skilled employees, while supply has only gradually been building up in response.

Net FDI grew by 12.5% to €1.9 billion in 2008, bringing the cumulative net FDI inflow to €13.3 billion since 2000. 50% of the totals foreign direct investment originated from Austria, Greece, Norway and Germany. The three sectors receiving most foreign direct investment were financial intermediation, transportation and telecommunication as well as manufacturing. Funds from the National Investment Plan have been used for various infrastructure projects such as the Belgrade ring road and motorways in southern Serbia, but also in order to stimulate foreign investment and job creation. The policy has lately changed into the financing of only a limited number of larger projects. Continuation of the construction of Corridor X, development of infrastructure for the car centre in Kragujevac, and investment in the 40 least developed municipalities are priorities for Serbia in 2009.

The total budget for expenditure under the National Investment Plan fell to €210 million for 2009 (in 2008 it stood at €600 million). *Overall*, investment activity from domestic sources has been declining, and foreign investors have become more hesitant, primarily due to growing the global economic downturn.

Sectoral and enterprise structure

Progress in selling state-owned companies was hampered by the global economic crisis, which significantly reduced interest in for acquiring such companies. Restructuring and privatisation on the other hand have been slow. The shift of economic activity towards the service sector is continuing, with services currently accounting for more than 60% of GDP. About 40% of all employees are working in state-owned enterprises or the public administration. 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. *Overall*, the pace of structural adjustment of the economy is being held back by slow reforms, and has lately been aggravated by the economic crisis.

State influence on competitiveness

Subsidies from the consolidated state budget remained high (at 1.8% of GDP) and they even rose by 36% in real terms in 2008. While relevant legislation on state aid control was adopted in July 2009, the appropriate monitoring mechanism and authority are still missing. State-controlled monopolistic structures remain in place. *Overall*, state influence on competitiveness remained substantial.

Economic integration with the EU

In January 2009, Serbia started implementing the Interim Agreement.

The EU remained Serbia's main trading partner. Exports and imports of goods to and from the EU increased by 11.8% and 11%, respectively, in 2008 compared to the 2007 figures, accounting for 53% of Serbia's overall trading volumes. However, as economic activity in the country slowed down due to the global financial crisis, a significant decrease was noted in the first quarter of 2009, with both exports and imports of goods from Serbia to the EU decreasing considerably, by 25.3% and 26.8% respectively.

Standard indicators suggest that the deterioration in export price competitiveness of recent years stopped in 2008. Real gross wages grew by 4.1% less than average labour productivity (estimated at 6.1%), resulting in a 1.8% decrease in real unit labour costs. In 2008, the nominal effective exchange rate of the dinar depreciated by 11.4%. In real effective terms, the dinar depreciated by 4.9%, despite consumer prices growing faster on the domestic market than abroad. *Overall*, trade integration with the EU remained high and export competitiveness has slightly improved.

7.3. CONCLUSION

The economy of Serbia was severely hit by the current global economic crisis. Growth slowed down by the end of 2008 and the economy entered into recession in 2009. As a result, macro-economic stability has deteriorated. Moreover, previously expansionary policies and the lack of discipline have led to a significant fiscal deterioration.

As regards the economic criteria, Serbia made only limited further progress towards establishing a functioning market economy. Further efforts will be needed to enable Serbia to cope in the medium-term with the competitive pressures and market forces within the EU. Structural reforms need to be accelerated.

The liquidity of Serbian banking system has been maintained and Serbian banks are well capitalised and by and large profitable. On the external side, the Serbian economy is going through a process of rapid external adjustment. This is reflected in a substantial decrease in the current account deficit. Foreign exchange reserves remained stable. Consensus on the fundamentals of a market economy has been maintained, but the government lacks a medium-term structural reform strategy.

In response to the deepening economic crisis, Serbia requested assistance from the IMF and the EU and agreed to undertake a number of fiscal measures to reduce overall expenditure. However, as the crisis aggravated, the IMF programme was revised. Measures to improve the medium-term public finance sustainability are lacking. The monetary policy framework for inflation targeting remained difficult to implement and risks undermining the credibility of the central bank. Inflation remained relatively high. Some progress was made in privatisation of socially-owned companies, but not with the state-owned companies, thus affecting the dynamism in the private sector. Unemployment remains at a persistently high level. Excessive administrative requirements continued to hamper market entry and exit. Legal predictability needs to be improved, in particular with respect to effective enforcement of property rights. The informal sector remains an important challenge.

8. KOSOVO (UN 1244)

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.

8.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The government of Kosovo has adopted its fourth Medium-Term Expenditure Framework (MTEF), covering the years 2010-2012. However, this document has not been used as a medium-term policy planning tool. The path documented in the MTEF for Kosovo's fiscal and external balances appears difficult to sustain and the White Paper on social policies is not included, despite commitments made by the authorities at the 2008 International Donor Conference. In general, new pieces of legislation continued to be submitted to the government with no link to the MTEF or any other medium-term policy framework. The weak rule of law continued to be a major obstacle to socio-economic development.

In March 2009, the first meeting in the framework of the fiscal surveillance mechanism with the European Commission took place in Pristina. On 29 June 2009, Kosovo became a member of the International Monetary Fund and of the World Bank. *Overall*, political consensus on the fundamentals of market-oriented economic policies has been maintained. However, the legal framework and the practices of a modern public financial management are sill lacking. The public administration has insufficient capacity.

Macroeconomic stability

Real GDP growth in 2008 was 5.4%, up from 5.0% in 2007. Contrary to 2007, a year in which private sector dynamism was the main source of economic growth, economic activity in 2008 and in the first half of 2009 was increasingly driven by the acceleration of public capital spending. Annual growth in private consumption stood at 11.3%, public consumption grew by 3%, and while public investment increased by 194%, private sector investment declined by 10.2%. The latter resulted partly from the decline in foreign direct investment and the stagnation of the privatisation process. As a consequence of the global economic crisis, since late 2008 exports have been decreasing. However, Kosovo's limited integration into the global economy and a stable financial sector pursuing conservative strategies have so far delayed a stronger impact of the crisis. In addition, the persisting weakness of the statistical system does not allow for a comprehensive assessment of the economic situation in Kosovo.([1]) According to IMF estimates, GDP per capita([2]) in 2008 reached €1,726, which corresponded to 6.9% of the EU-27 average compared with 6.5% in 2007. *Overall*, the unfolding of the crisis affected Kosovo's economy to a limited extent so far. However, the lack of data does not allow a robust assessment for the previous or current year.

In 2008 exports of goods increased by 20.2%, reaching 5.3% as a share of GDP. As in previous years, they were driven by base metals and base metal products, accounting for more than 60% of overall exports in 2008 and increasing 67% over 2007. The second most important export category, mineral products, showed a decrease of about 32% in 2008 vis-à-vis 2007, as international demand fell due to the crisis. In the first half of 2009 exports fell substantially by 39.9%, with the base metals category

([1]) The Statistical Office of Kosovo (SOK) has published nominal GDP figures for the years 2004-2007, stressing at the same time that the number and the quality of existing statistical surveys are insufficient for successful implementation of national accounts according to ESA 95 standards.

([2]) A measure using PPP is not available for Kosovo.

shrinking by close to 60%. Imports of goods increased by 22.1% in 2008, reaching 50.2% of GDP, up from 44.2% of GDP in 2007. Mineral products (mainly oil), prepared foodstuffs, base metals and machinery remained the largest import categories. Total imports decreased by 1.6% but more than two thirds of the commodity groups still registered positive growth rates.

Table 8.1:
Kosovo* - Main economic trends

		2004	2005	2006	2007	2008	2009 H1
Gross domestic product	Ann. % ch	3.4	3.8	3.9	5.0	5.4	n.a
Private consumption	Ann. % ch	3.6	8.6	4.0	8.1	3.2	n.a
Investment	Ann. % ch	-3.1	4.7	10.3	12.4	11.6	n.a
Unemployment	%	39.7	41.4	44.9	43.0	40.0	n.a
Employment	Ann. % ch	61.6	-1.1	-10.1	10.8	:	n.a
Wages	Ann. % ch	9.3	8.5	N.A.	N.A.	N.A.	n.a
Current account balance	% of GDP	-9.9	-9.8	-10.3	-10.2	-16.3	n.a
Direct investment (FDI, net)	% of GDP	0.6	2.6	7.7	16.7	13.1	n.a
CPI	Ann. % ch	-1.1	-1.4	0.6	4.4	9.4	-2.6
Interest rate (3-12 months)	% p.a.	15.70	15.60	15.47	15.49	16.61	15.71**
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	n.a
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
Real eff. exchange rate (CPI)	Index	-3.0	-5.0	-2.8	-0.1	N.A.	n.a
General government balance	% of GDP	-4.5	-3.0	2.4	7.0	0.0	n.a
General government debt	% of GDP	N.A.	N.A.	N.A.	N.A.	N.A.	n.a

* as defined by UNSCR 1244 ** Q1

Sources: Thomson Reuters/Ecowin

The coverage ratio of exported to imported goods, traditionally low, decreased to 6% in November 2008 (from 17% in July 2007), as exports contracted with the coming of the international crisis. Exports have further decreased since then. Consequently, the trade deficit widened to 46% of GDP in the first half of 2009, from 43% in 2008 and 39% in 2007.

The current account deficit — including official grants — increased from 10.2% of GDP in 2007 to 16.3% in 2008. Remittances and foreign assistance amounted to 12.1% of GDP (12.5% in 2007) and 7.7% of GDP respectively. Foreign direct investment (FDI) was 13.1% in 2008, compared to 16.7% in 2007. In 2007, about half of FDI was linked to the privatisation process and the licensing of the second mobile telephony operator, while in 2008 the privatisation process stagnated. As in previous years, the net balance on the capital and financial account was lower than the current account deficit, leaving a significant portion of the financing unexplained. *Overall*, an adjustment of the large trade deficit in the first half of 2009 did not take place as the large public works triggered substantial imports of machinery and transport equipment, whereas exports fell sharply.

The poor availability and reliability of labour market data continued to hamper the analysis of labour market developments. The registered unemployment rate in the first half of 2009 remains very high, estimated at 40%, unchanged compared to 2008. More than 90% of registered persons fall into the category of long-term unemployment. The Labour Force Survey also confirms that the unemployment rate is very high and around 40%. Uncertainties on the accuracy of these figures exist. They are based on the fact that little is known about how many of those who are registered unemployed are actually economically inactive and actively looking for employment. Some 30,000 young people enter the labour market every year and many of them continue to leave Kosovo to find work abroad. Labour is in fact Kosovo's biggest (non-recorded) export item and the labour force working abroad continues to generate a steady stream of income in the form of remittances which finances a large share of consumption in Kosovo. However, there are no official statistics on labour migration. *Overall*, the level of economic activity does not allow the young and growing labour force to be absorbed. For many, emigrating and working abroad remains the only viable option to support their families in Kosovo.

Average yearly consumer price inflation increased to 9.4% in 2008 from 4.3% in 2007. Monthly inflation rates on an annual basis turned negative in 2009, reaching -3.0% in August. Kosovo was strongly affected by higher food and energy prices between mid-2007 and mid-2008, partly due to the large share of food items in the CPI, but also due to low levels of competition in the economy. Main drivers behind recent negative inflation rate are the adjustment of food prices and lower costs for transportation. On the other hand, the prices of housing-related cost items, including energy and some services that are predominantly publicly provided, have been still rising. *Overall*, price developments reflect the falling international prices. Prices of domestic services have continued rising, partly due to weak competitive pressure in the economy.

The Central Bank of Kosovo (CBK) increased its scope of financial sector supervision and played a positive role in the management of risks related to the international financial crisis. It has also introduced high frequency monitoring of commercial banks. Whereas the CBK is the main institution for financial market regulation and supervision in Kosovo, due to Kosovo's use of the euro as official currency, the CBK has only limited policy instruments at its disposal, such as reserve and liquidity requirements. In the absence of autonomous monetary policy and given the fully euroised economy, real interest rate and real (effective) exchange rate movements remain difficult to predict. Uncertainties regarding property rights and weak rule of law continued to be the main factors for the high risk premiums demanded by the commercial banks. *Overall*, the stability of the financial sector benefited from improved supervision.

After the 2007 budget execution had led to a substantial increase in the government cash reserves, the 2008 fiscal year ended with a broadly balanced budget and government's cash reserve at close to EUR 470 million. Total revenues decreased from 25.9% of GDP in 2007 to 25.3% of GDP in 2008. Revenue collected by the customs services accounted for 64.1% of total government revenues, up from 58.9% in 2007. Total expenditure increased by 44.0% in 2008, reaching 25.3% of GDP, after 18.9% of GDP in 2007. Wages and salaries increased by 9.3%, subsidies and transfers by 32.6%, and capital outlays almost tripled (194.4%) compared to 2007. Thus, public investment reached 7.7% of GDP, up from 2.8% in 2007. Expenditures showed a highly volatile profile. In the first half of 2009 government expenditure continued to rise – wages and salaries were up by 17.0%, subsidies and transfers rose by 25.4% from an already high base in 2008, capital outlays were 34.8% higher than during the first half of 2008. In the first half of 2009 public revenues were not substantially affected by the crisis and they increased by 2.9% compared to the same period in 2008. *Overall*, the 2008 budget was marked by strongly increased spending on capital investment and subsidies and transfers. In view of the challenging economic environment, revenue collection in the first half of 2009 held up well.

With regards to fiscal planning, the Ministry of Economy and Finance (MEF) continued to receive incomplete information from line ministries on important strategic developments with fiscal implications. An important example was the limited involvement of the Ministry in the transformation of the state-owned energy sector, in spite of its high and increasing needs for transfers and subsidies from the budget. The 2009 budget was influenced by the electoral agenda([1]) and contained large increases in public wages, which lead as a consequence to a continued breach of the fiscal rule as

([1]) At the time the 2009 budget was prepared, the working assumption based on the Ahtisaari package was to hold general elections in 2009.

spelled out in the previous MTEF.([1]) The government also continued to initiate legislation without linking it to the MTEF or any other medium-term policy planning document that could ensure some consistency of policies over time. Neither the budget, nor the MTEF have developed into efficient policy instruments. Instead, they continued to respond to ad hoc spending pressures.

Overall, given the absence of autonomous monetary policy, the burden of macroeconomic adjustment remained with fiscal policy; however, the low quality of budgetary planning and execution show that it has to yet fully assume its responsibility for macro-economic stability.

Interplay of market forces

The Competition Council started implementing antitrust policy. The Privatisation Agency of Kosovo (PAK) replaced the Kosovo Trust Agency in June 2008. The PAK resumed the process of privatising socially-owned enterprises in the second half of 2008, albeit at a modest pace and equally modest volumes, processing marginal assets, therefore without a clear impact on overall economic activity. Since April 2009, there has been a slight acceleration of the privatisation process. The government's privatisation agenda concerning public-owned enterprises continued to accumulate delays. *Overall*, delays in privatisation contributed to a rigid business structure.

Market entry and exit

By the end of 2008 there were 67,950 active companies, 83% of them operating in the services sector. 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. *Overall*, weak administration and rule of law, unreliable energy supply, limited access to finance, corruption and poorly defined property rights, the tackling of which is mentioned as a key priority in the 2008 European Partnership, hinder market entry and exit.

Legal system

The need to strengthen the legal framework is a key priority in the 2008 European partnership. Kosovo's legal system is a complex mix of different legal acts produced by the Yugoslav administration before 1999, and successively by UNMIK and the Kosovan Government since then, which leads to uncertainty. As a general rule, legislation after 1999 has been supportive of a free-market economy. The legal system continued to exhibit poor accessibility and efficiency, and some areas are not covered by relevant courts. As a consequence, informal methods of contract enforcement continue to be widespread. 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. *Overall*, the weak rule of law and uncertainty over property rights remained major impediments to sustainable economic development. The difficult and costly legal enforcement of contracts hindered access to finance and continued to hamper seriously the business environment.

Financial sector development

The financial sector in Kosovo continued its expansion, albeit at a sharply reduced pace compared to previous years. Eight commercial banks, ten insurance companies and two pension funds are operating in Kosovo so far. As a response to the international financial crisis, the Central Bank of Kosovo established a Crisis Preparedness Committee (CPC) and signed a Memorandum of Understanding on safeguarding financial stability with the Ministry of Economy and Finance. The newly created procedures have yet to be tested. Reporting requirements for banks have been tightened

([1]) The rule limited the growth of primary current spending to 0.5% in real terms.

and banks have been requested to gradually reduce their net exposure to their parent banks to the level prescribed by the CBK's rule (20% of Tier I capital). There has been increased exchange of information with foreign central banks and other supervisory authorities, as well as with the boards of key players in the banking sector. The quality of the loan portfolio in Kosovo's banking sector remained solid, with the average share of non-performing loans in 2008 reaching only 3.3% from 4.4% in 2007. *Overall*, prudential indicators of profitability and liquidity remained favourable in 2008 and no specific crisis-related interventions have been needed so far. However, there are also indications on poor access to finance and high perceived risk of doing business.

The banking sector continues to dominate the financial sector and remains highly concentrated, with the three largest banks, foreign-owned, holding almost 90% of total assets. Profits rose by 8.7% in 2008, sharply down from growth of 68% in 2007. The degree of financial intermediation increased further, though from a still modest level. The share of banking sector assets in GDP grew from 41.4% in 2007 to 48.6% in 2008. The volume of loans increased from 25.8% of GDP in 2007 to 31.8% in 2008. In May 2009, annual credit growth was 20.4%, whereas deposit growth stood at 21.4%, and the loans to deposit rate stood at 84.5%. While there is no legally binding restriction, there is an informal agreement according to which the ratio of loans to deposits should not exceed 80%. Since February 2008, the ratio has been constantly above this level, as credit growth has become strictly bound by the rate of deposit growth. The interest rate spread between deposits and loans remained very high and showed only a slow downward trend. By end of May 2009, the spread's 12 month average for all types of loans stood at 10.1 percentage points, slightly down from 11.3 percentage points in 2007. The spread is lower for loans to households (9.2) than for loans to (non-financial) corporations (11.2). Loans distribution across sectors remained highly uneven. By the end of May 2009, agriculture continued to account for only 4% of outstanding business loans, the secondary sector (manufacturing, energy and construction) taking up close to 21%, while 75% of all business loans financed activities in the service sector. While there was no change in the sectoral structure of the loan portfolio, there was some improvement in the maturity structure. By the end of May 2009, 62% of business loans had a maturity of 2 years or more, up from 57% at the end of 2007. *Overall*, the number of loans has increased but high real interest rates remain one of the major obstacles to doing business in Kosovo. Ineffective enforcement of creditor rights and of contracts continues to maintain high costs and risks for financial institutions, as reflected in high interest spreads, and undermines the value of collateral.

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

Existence of a functioning market economy

Since 1999, newly adopted legislation supports a free-market economy. However, there was very little progress in strengthening the overall framework for a functioning market economy. The regulatory framework is incomplete in many areas relevant for the economy, the implementation and enforcement of existing rules remain weak, and there is a lack of good governance. In addition, provisions implementing key pieces of legislation are missing, or contradictory. Private sector companies are confronted with procurement and tendering procedures that lack transparency, a stable set of administrative rules and financial controls, as well as economic impact assessments. Neither the relevant procurement agencies, nor the courts have so far been able to deal successfully with the arbitrary application of selection criteria. The stability of the energy supply was improved, however at the cost of ever higher subsidies from the budget. *Overall*, an incomplete legal framework, corruption, weak rule of law, high level of informal activities and a highly subsidised energy supply continued to impair the efficiency of market mechanisms.

Human and physical capital

Some progress took place in the education sector, in particular concerning accreditation and qualifications, and in the consolidation of the university. Despite this, the education system continued to suffer from lack of resources and unreliable or missing qualification and certification schemes. 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. *Overall*, little progress was made towards better developing the economic potential of Kosovo's young population.

No comprehensive information on investment developments is available. Kosovo has initiated major public works to upgrade its road network, absorbing an increasing share of budgetary resources. However, poor procurement procedures and weak financial controls cast doubts on the quality and the capacity to respond to actual needs of the ongoing works, as well as the quality of the actual works. Mobile telephone penetration continues to increase and is estimated at more than 50% by mid-2009. *Overall*, the technology base and the state of physical infrastructure remain weak and the pool of qualified human capital small. As a result, Kosovo companies are too rarely competitive even in sectors where competitive potential exists.

Sectoral and enterprise structure

Regulatory authorities have been set up for all major network and commodity industries, but they remained weak. Their independence was undermined by politicisation of appointments in their boards. In several instances, the potential positive effects of market liberalisation cannot materialise due to weak corporate governance and the absence of consumer protection. Kosovo cannot yet benefit from regional energy trading with its neighbours on a level playing field due to unfinished integration into regional electricity trade agreements. Electricity supplies continue to be intermittent due to the outdated system and strains caused by an unsustainable increase in demand. Whilst power bill collection has increased slightly, some 50% of power produced is still unpaid for. Electricity demand continues to increase faster than economic growth. A new power plant will only come on stream in five years at the earliest. Further unbundling and privatisation of the generation and distribution companies is planned in the next year. The enterprise structure is unchanged, dominated by micro-enterprises. Measures have been adopted to start reducing the large informal economy, such as overhauling the tax system, and measures taken to address evasion. *Overall*, there have been few changes in the enterprise structure, which remains dominated by micro-enterprises, and the large informal economy remains a challenge.

State influence on competitiveness

According to budget figures, subsidies and transfers increased by 32.6% in 2008 and by another 25.4% in the first half of 2009. A large share of these goes to the loss-making public electricity company KEK. Widespread electricity theft and tolerance towards unpaid power bills has undermined the viability of the power utility, and continued to trigger additional energy imports paid from the government budget. *Overall*, ongoing direct and indirect state subsidies, combined with a poor level and quality of public services, continued to hamper private-sector competitiveness.

Economic integration 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 71.1% in 2008, up from 64.5% in 2007. EU Member States and CEFTA continued to be the two main trading partners for Kosovo, accounting for 40% of total trade each, the latter despite Serbia's blocking the exports and Bosnia and Herzegovina's refusing preferential treatment. The share of exports bound for the EU increased from 42% in 2007 to 47.8% in

2008. The EU's share of total imports remained at around 36%. *Overall*, economic integration with the EU has increased.

8.3. CONCLUSION

The economy of Kosovo has been only moderately affected by the crisis so far. GDP continued growing, albeit from a very low base, but unemployment remained very high. High inflation has turned into deflation, following drops in the prices of imports. Economic development continues to be seriously impeded by weak rule of law, a very limited and poorly diversified production capacity, and by a weak transport and energy infrastructure. Fiscal policies are driven by ad-hoc demands and lack a systematic link to the medium-term policy framework. The stability of the energy supply improved, at the cost of increasing subsidies from the budget.

As regards the economic criteria, Kosovo has made very little progress towards establishing a functioning market economy. Considerable reforms and investments must be pursued to enable it to cope over the long term with competitive pressure and market forces within the Union.

A broad consensus on free-market policies has been maintained. The use of the euro, the absence of significant amounts of external debt and the very low level of exports have shielded the economy from the negative effects of the global recession. The banking sector remained sound, profitable and well capitalised. Economic growth was driven by the continued expansion of credit and by increased foreign assistance. After a significant surplus in the previous year, the 2008 budget posted a small deficit. Fiscal revenues increased slightly. In June, Kosovo joined the International Monetary Fund and the World Bank.

However, the already large trade deficit continued to widen, notably due to substantial imports of machinery and transport equipment for a major road construction programme. Both fiscal and external accounts became even less sustainable, mainly as a result of poor policy planning and implementation. Exports fell sharply in 2009, from an already very low base, as a consequence of the economic crisis. Economic statistics remain inadequate. The cost of finance remained high, as banks continued to attach high risk premiums to business loans. Budget subsidies and transfers increased. The weak rule of law, corruption, prevalent in many areas, and uncertainty over property rights continued to be major impediments to economic development. Unemployment remains very high. Little progress was made towards an increased integration of Kosovo's young population into the labour market. The informal sector continues to pose an important challenge.

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

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