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Progress towards meeting the economic criteria for EU accession: the EU Commission's 2012 assessments

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European Commission
Directorate-General for Economic and Financial Affairs
Publications
B-1049 Brussels
Belgium
E-mail: mailto:Ecfin-Info@ec.europa.eu

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

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2012 European Commission's Progress Reports for candidate countries and potential candidates for EU accession, of the Comprehensive Monitoring Report (CMR) on Croatia as well as of the Feasibility Study on a Stabilisation and Association Agreement with the EU for Kosovo*. The Commission prepared Progress Reports for the candidate countries the former Yugoslav Republic of Macedonia, Iceland, Montenegro and Turkey as well as for the potential candidates Albania and Bosnia and Herzegovina. The European Commission adopted these Progress Reports, the CMR on Croatia and the Feasibility study on Kosovo* on 10 October 2012.

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 2012 Progress reports, i.e. the Commission staff working documents for each of the candidate countries and potential candidates.

The methodology of the Progress Reports

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

The criteria are:

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

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

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

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

Difference between Progress Report and the Feasibility Study on Kosovo

The 2012 Progress Reports focus on developments during the period October 2011 - September 2012 and seek to assess progress on the two Copenhagen criteria: (1) existence of a functioning market economy and (2) capacity to cope with competitive pressure in the EU. The assessment in the Feasibility Study on Kosovo* covers a broader time span as compared to the Progress Reports, and contains a stock-taking of advancement with the two economic criteria.

The economic sub-criteria

Regarding the economic criteria, the Commission has examined progress achieved during each year on the basis of a number of sub-criteria applied since 1997. According to these the existence of a functioning market economy requires that:

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

- significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;

- the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;

- macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;

- broad consensus exists about the essentials of economic policy;

- the financial sector is sufficiently well developed to channel savings towards productive investment.

- The capacity to withstand competitive pressure and market forces within the Union is assessed on the basis of the following factors:

- the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;

- a sufficient amount, at appropriate costs, of human and physical capital, including infrastructure, education and research, and future developments in this field;

- the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.;

- the degree and the pace of trade integration a country achieves with the Union before enlargement. This applies both to the volume and the nature of goods already traded with Member States;

- the proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust.

It is important to note that these conditions do not serve as a simple checklist. First, the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, are pertinent. Second, there is an important time dimension involved. Meeting the economic criteria requires deep and lasting structural reforms that take time to be accomplished. The issue of track record becomes then very relevant. In this context, the concept of track record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.

The conclusions of the reports

The conclusions of the assessments in the economic chapters are provided at the end of each country section in this publication. An important difference in the nature of the Progress Report's conclusions for candidate countries on the one hand and potential candidate countries on the other hand should be noted. Namely, in the case of candidate countries the conclusions summarise the state of compliance with the Copenhagen economic criteria (= level of compliance), while in the case of the potential candidate countries they rather refer to the progress achieved towards compliance. The reason for this is that for each candidate countries the Commission has already assessed the level of compliance for the first time in its respective opinion on the countries' EU membership application. This exercise has not yet been undertaken for the potential candidates, and therefore the assessment and the conclusions can naturally only refer to further progress achieved rather than to the level of compliance.

Progress towards meeting the economic criteria for EU accession:

The EU Commission's 2012 assessments

1. CROATIA

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

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Croatia’s Pre-accession Economic Programme (PEP) for 2012-2014, submitted in March 2012, presented a comprehensive, though optimistic, macroeconomic and fiscal framework for economic policies. The government plans to consolidate public finances by reining in expenditures while stimulating economic growth through infrastructure-oriented investments by publicly owned companies. Monetary policy continues to be conducted within the framework of exchange rate stability vis-à-vis the euro. The consensus on the fundamentals of a market economy was maintained.

Macroeconomic stability

In 2011, annual GDP is estimated to have stagnated (-0.0%) in real terms compared to 2010. GDP still declined in the first quarter, then started to expand in the second and third quarters, before contracting again in the final quarter. Final domestic demand continued to contract in 2011, particularly due to a further drop in investment activity (-7.2%). Private consumption was slightly positive (+0.2%), but this was partly offset by lower public consumption (-0.3%). The level of real GDP was held up by inventory accumulation, which contributed 1.1 percentage points to growth. Net exports added 0.4 percentage points to GDP growth as exports of goods and services expanded faster than imports. GDP per capita in purchasing power terms remained unchanged from 2010 at 61% of the EU-27 average.

The renewed output decline accelerated in the first seven months of 2012. Following a 0.4% contraction in the fourth quarter of 2011, GDP declined by 1.3% year-on-year in the first quarter and by 2.2% in the second quarter of 2012. In July, the monthly indicators of economic activity were all sharply lower in real year-on-year terms: retail sales by -5.1%, industrial production by -5.5% and construction output by -9.7%. The current account deficit narrowed from 1.1% of GDP in 2010 to 0.9% in 2011 before widening again in the first quarter of 2012. Like in the preceding year, Croatia’s trade performance in 2011 indicated a lack of international competitiveness. Market share was lost as exports of goods and services increased by 2.0% in volume terms while the weighted export market grew by 5.4%. Imports of goods and services in volume terms increased by 1.2% although domestic demand contracted by 0.6%. Inflows of foreign direct investment were € 1 billion, which was far below the pre-recession level, but 3 times higher than in 2010. Gross external debt declined slightly from a revised 105% of GDP at the end of 2010 to 103% at the end of 2011 before returning to 105% in mid-2012. Gross international reserves increased from 24.1% of GDP at the end of 2010 to 25.2% at the end of 2011 and further to 26.1% at the end of July 2012 helped by a large foreign-bond issue by the government in April. Despite a significant stock of international reserves, the high level of gross external debt remains a key vulnerability of the Croatian economy.

The labour market continued to deteriorate in 2011. Unemployment was high at 13.5%, a 1.7 percentage point increase on the previous year. Employment fell by 3.2%. The rising trend of unemployment continued into 2012. In July the registered unemployment rate was 0.7 percentage points higher year-on-year. There has only been little progress in reducing the structural weaknesses of Croatia’s labour market, which are reflected in low employment and participation rates and high rates of youth and long-term unemployment. In 2011, the employment rate declined to 52.4%, the participation rate fell to 60.8%, while youth unemployment increased to 36.1%.

Table 1.1:
Croatia - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	5,1	2,1	-6,9	-1,4	0,0	-1,8
Private consumption	Ann. % ch	6,3	1,3	-7,6	-0,9	0,2	-1,9
Gross fixed capital formation	Ann. % ch	7,1	8,7	-14,2	-15,0	-7,2	-4,4
Unemployment	%	9,6	8,4	9,1	11,8	13,5	15,5
Employment	Ann. % ch	1,8	1,3	-1,9	-4,0	-3,2	-3,3
Wages	Ann. % ch	6,2	7,1	2,2	-0,4	1,5	1,5
Current account balance	% of GDP	-7,3	-9,0	-5,2	-1,1	-0,9	-0,7
Direct investment (FDI, net)	% of GDP	7,9	6,7	3,4	0,9	2,3	2,6
CPI	Ann. % ch	2,9	6,1	2,4	1,0	2,3	2,5
Interest rate (3 months)	% p.a.	5,66	7,19	8,96	2,44	3,14	4,03
Stock markets	Index	4.673	3.299	1.871	1.990	2.079	1.752
Exchange rate HRK/EUR	Value	7,33	7,22	7,34	7,29	7,43	7,54
Nominal eff. exchange rate	Index	98,0	96,1	97,2	98,2	100,2	102,5
General government balance	% of GDP	-2,5	-1,4	-4,1	-4,9	-5,1	N.A.
General government debt	% of GDP	32,9	29,3	35,8	42,2	46,7	50,5

Sources: Thomson Reuters/Ecowin, Eurostat

Consumer price inflation increased from 1.1% in 2010 to 2.3% in 2011, mainly as a result of higher international prices for energy and food commodities and their pass-through to related domestic prices. A small depreciation of the domestic currency contributed also to the rise in the price level. Due to the slack in resource utilisation, not least in the labour market, underlying inflationary pressures have remained low on the domestic side. However, a 2 percentage point increase in the general VAT rate and increases in administered energy prices have pushed up the year-on-year increase of consumer prices to 2.8% in the first eight months of 2012.

Monetary policy succeeded in preserving exchange rate and financial stability. It remained oriented towards a tightly managed kuna/euro exchange rate with little variability, but without a formal peg to the euro. This monetary framework anchors inflation expectations and reduces exchange rate-related credit risks in the highly euroised economy. The kuna appreciated by 1.4% against the euro between the beginning of October 2011 and 19 September 2012. In this period, the central bank stabilized the kuna/euro rate by selling € 724.4 million and by buying € 58.1 million in the foreign exchange market. On two occasions the central bank supported the domestic currency by raising the reserve requirement rate for banks, but was able to reverse most of these increases when the kuna was strengthening. Foreign exchange liquidity was expanded by lowering the rate of minimum required foreign exchange currency claims of banks relative to their foreign currency liabilities. Overall, monetary policy was able to maintain an appropriately accommodative stance in a context of persisting recessionary conditions.

Fiscal policy has, to some extent, contained the negative budgetary consequences of the continuing recession. In 2011 total expenditures of general government were held unchanged year-on-year in nominal terms as stipulated by the Croatian parliament in August 2010. The share of social transfers in total expenditures was reduced somewhat, but huge scope remains for increasing the efficiency of public spending through better targeting of social support. Total revenues declined by 0.6%, mainly as a result of changes in the tax legislation in the preceding year. Net borrowing by general government increased from a revised 5.0% of GDP in 2010 to 5.1% of GDP in 2011. This outcome is significantly below the budgeted deficit (5.6% of GDP) mainly because realised public investment expenditure was 0.5 percentage points of GDP below budget. General government consolidated gross debt increased from 42.2% of GDP at the end of 2010 to 50.5% at the end of June 2012 (excluding outstanding state guarantees and the debt of the State Development Bank). A tax reform in February 2012 included an increase in the general VAT rate from 23% to 25% and a reduction in the employers' contribution to the compulsory health insurance from 15% to 13%. The Ministry of Finance projects a general government fiscal deficit of 3.9% of GDP in 2012. Revenues are budgeted to increase by 1.7% while expenditures are projected to decrease by 1.2%. In the first half of 2012, net borrowing of general government amounted to 2.0% of projected full-year GDP. The Ministry's current budgeting is based on the optimistic assumption of stagnating real GDP in 2012. Overall, the budgetary process continued to show weaknesses. The efficiency of public spending needs to be enhanced in order to ensure medium-term fiscal sustainability.

Interplay of market forces

The private sector's share of GDP and employment has remained at around 70% of the overall economy. In the twelve months to the end of June 2012, the Government Asset Management Agency (GAMA) reduced its holdings from 693 to 649 companies. The proceeds of the sales were relatively modest since many of the companies were liquidated in the process. GAMA's remaining portfolio consists predominantly of highly indebted and often loss-making companies. Overall, little progress has been made towards reducing the large role of the state in the economy.

Market entry and exit

The legal framework for companies entering and leaving the market did not change significantly in the reporting period. The average number of active legal entities in 2011 was 9.4% lower than in 2010. The investment climate remained hampered by difficulties in obtaining the necessary licences, building permits and other authorisations; by uncertainties arising from changes in the legal environment; and by the lack of certainty and uniformity of public administration decisions and the length of the related procedures, particularly at local level. A large number of non-tax fees at national and local levels continue to be a significant burden for entrepreneurs although their number and rates have been reduced. Overall, lengthy procedures and numerous non-tax fees hamper business start-ups and the business environment in general.

Legal system

The weaknesses of the judicial system continue to hinder the effective enforcement of creditor and property rights. The length of court proceedings remains generally excessive and problems persist with the enforcement of court decisions. Investors still face problems regarding the registration of property. The business environment continues to suffer from inefficiencies in the public administration.

Financial sector development

The financial sector continued to be dominated by banks, which held 75% of the total assets of financial intermediaries at the end of June 2012. Market concentration has remained moderate, with the four largest banks continuing to hold about two thirds of total banking assets. Banking sector assets were 1.9% higher year-on-year at the end of July 2012 and amounted to 122% of GDP. The sector has remained stable and well capitalised with the capital adequacy ratio increasing to 20.2% at the end of June 2012. Bank profitability has generally remained depressed since 2009. There was a slight improvement in the return on equity for banks in 2010 and 2011 followed by a renewed decrease in the first half of 2012. The quality of bank loans continued to deteriorate, with the share of non-performing loans in total loans rising by 1.4 percentage points year-on-year to 13.3% at the end of June 2012. The largely unhedged foreign exchange liabilities of the non-financial private sector remain a significant risk.

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

Existence of a functioning market economy

Croatia is a functioning market economy. The monetary policy stance has remained appropriate given the existing constraints imposed by the very high level of external debt while fiscal policy has contained the rise of the budget deficit under recessionary conditions.

Human and physical capital

Further steps were taken to improve the quality of education at all levels. The government continued its programme of active labour market policy measures, but rigidities in the labour market remain a major challenge.

Investment fell for a third consecutive year in 2011, again mainly due to a drop in construction activity. As a share of GDP, investment declined from 21.6% in 2010 to 19.8% in 2011. Foreign direct investments, particularly greenfield investments, remained scarce. The 30 public-sector investment projects (mainly in energy, tourism, water management and transport infrastructure) which the government announced in late 2010 have not materialised. The new government's Investment Cycle Plan schedules investments by publicly-owned companies, mainly through public-private partnerships and with funds from international financial institutions. These projects focus predominantly on energy, infrastructure and education.

Sector and enterprise structure

The services sector increased its share of total gross value added slightly, from 69.3% in 2010 to 69.7% in 2011. The share of industry rose from 18.4% to 18.8% while the share of agriculture, forestry and fishing fell from 5.5% to 5.4%. These gains were made at the expense of construction, whose share of total gross value added further declined, from 6.8% in 2010 to 6.1% in 2011. Small and medium-sized enterprises (SMEs) continued to account for around 50% of GDP, their share of total exports amounted to around 40%, and they employ more than 63% of all employed people. The government continued to support SMEs through the Croatian Agency for SMEs (HAMAG Invest) and the State Development Bank (HBOR).

State influence on competitiveness

State aid amounted to 2.8% of GDP in 2010 and preliminary data indicate that it was in the range of 2.6–2.8% of GDP in 2011. Sector-specific aid, including for agriculture and fisheries, represented 87% of overall State aid in 2010, with the remainder going to horizontal aid (research and development, employment, SMEs, environmental protection, training, etc.). There has been little change in the share of horizontal aid in total State aid in the period 2008-2010.

Trade integration

Croatia is an open economy with total trade in goods and services accounting for around 82% of GDP in 2011, up from 77% in 2010. The EU has continued to be Croatia's largest trading partner. Its shares of total Croatian exports and imports of goods remained relatively stable in 2011 at 60% and 62% respectively. 91% of all FDI stocks stemmed from EU Member States. Overall, integration with the EU in the areas of trade and investment remained high.

The kuna depreciated slightly in real effective terms in 2011. The depreciation amounted to 2.4% year-on-year on the basis of consumer prices, 1.4% on the basis of producer prices, and 0.9% on the basis of unit labour costs. Unit labour costs decreased due to rising labour productivity. Overall, standard indicators point, on balance, to a slight improvement in Croatia's international price competitiveness in 2011.

1.3. CONCLUSIONS

The economy of Croatia stabilised temporarily in mid-2011 before returning to recession towards the end of the year. The economic contraction continued in the first half of 2012. Unemployment, public deficit and debt continued to increase in 2011 from already high levels. The high external indebtedness remains a key vulnerability of the economy.

As regards the economic criteria, Croatia is a functioning market economy. Vigorous implementation of urgently needed structural reforms should enable Croatia to cope with competitive pressures and market forces within the Union in the near term.

Broad political consensus on the fundamentals of a market economy was maintained. Given the existing constraints, macroeconomic policy has, by and large, been appropriate. The central bank succeeded to preserve exchange rate and financial stability while maintaining a relatively accommodative monetary policy as underlying inflationary pressures stayed low. The banking sector remained well capitalised. In the fiscal area, the authorities made efforts to contain the rising deficit by reining in expenditures. The current account deficit remained at a low level as a renewed rise of imports was offset by increasing exports. Gross external debt has stabilised, albeit at a very high level.

Structural reforms progressed slowly in some areas, not least with respect to privatisation and the restructuring of loss-making enterprises, and were almost non-existent in others. In the area of labour markets in particular, where already low levels of employment and participation declined further, reforms are still at a very early stage and need urgently to be stepped up. The investment climate continued to suffer from a heavy regulatory burden, lengthy procedures, uncertainties in the legal environment, unpredictability of administrative decisions, and a high number of non-tax fees. Social transfer payments, which represent a relatively high share of public budgets, remained not well-targeted. Considering the need to achieve medium-term fiscal sustainability, the budgetary process could be improved further. Enhancing the efficiency of public spending remains a key challenge.

2. ICELAND

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

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Broad political consensus on the key essentials of a market economy and the preservation of a welfare state continues to be strongly embedded in Iceland's society. The authorities proceeded with domestic debt restructuring, financial sector stabilisation and fiscal consolidation. Following the first post-crisis international bond issue in mid-2011, the country was able to sell a USD 1 billion bond to foreign investors in May 2012 at a yield of 6%. Early repayments of IMF and Nordic loans started in March 2012 and continued in June. Furthermore, Iceland was restored to investment grade status by major rating agencies. The country submitted its second Pre-Accession Economic Programme (PEP) in January 2012. It presents a broadly plausible medium-term macroeconomic scenario and a relatively ambitious fiscal framework. Both are subject to considerable downside risks and are not fully underpinned by supporting structural reform measures. Overall, economic policy has been geared towards further stabilisation.

Macroeconomic stability

Following a deep and long recession, the Icelandic economy eventually turned to growth in 2011. Real GDP increased by 2.6%, after economic activity had declined by 4% a year before. The recovery was driven by a 2.7% growth in private consumption, which benefited from temporary income-boosting measures provided to households, such as early third-pillar pension withdrawals, temporary increases in subsidies and transfers and debt relief schemes. Investment activity recorded growth of 12.8%, driven by a close to 26% increase in business investment. At the same time, the contribution of net exports to growth remained negative, as strong domestic demand led to an acceleration of imports. In the first half of 2012, the economy continued to grow, at 2.4%, somewhat weaker than earlier expected and based on robust private consumption and investment demand. Net exports continued to be a drag on growth as import growth outpaced export growth. High frequency and leading indicators point towards a continued growth in the third quarter, including a pick-up in the construction sector. While the recent growth pattern has become more broad-based, remaining balance sheet vulnerabilities in both the corporate and household sectors as well as the challenging global outlook and the euro area debt crisis could threaten the recovery process. Average per capita income (in Purchasing Power Standards) remained at 110% of the EU average in 2011. Overall, the economy continued to recover at a reasonably robust pace, but uncertainties persist regarding the sustainability of growth.

External trade developments point to a narrowing surplus in trade in goods and services, primarily due to stronger merchandise imports. The surplus fell from around 10.1% of GDP in 2010 to 8.5% in 2011 and further to 6.6% in the four quarters to June 2012. Thanks to a significantly lower deficit in the net factor income balance, the current account deficit declined from 8% of GDP in 2010 to 7% in 2011, however, it increased again to 8% in the four quarters to June 2012. Reported current account balances remain highly influenced by accrued interest of banks in winding-up proceedings which do not reflect any current (or future) outflow of funds. Corrected for these factors, the 'underlying' current account recorded a much lower deficit of 1.1% of GDP in 2011, down from 2.1% in 2010, according to the Central Bank estimates. Overall, while external imbalances improved compared to pre-crisis levels, the surplus in trade with goods and services narrowed.

Total net capital inflows in 2011 were larger than needed to finance the current account deficit. As a result, gross official foreign exchange reserves held at the Central Bank increased to close to 65% of GDP at year-end. In March and June 2012, Iceland repaid early around 55% of the € 3.5 billion loans received from the IMF and Nordic countries with a view to reducing short-term debt and costs of holding borrowed reserves. These transactions contributed to a moderate fall in the stock of gross reserves which stood at 45% of projected GDP in August 2012. At the same time, the high stock of external debt continues to represent a key challenge to the Icelandic economy. Official debt statistics report the stock of gross foreign debt at around 840% of GDP at end-March 2012. However, corrected for foreign debt of banks and holding companies in winding-up proceedings, the Central Bank estimates the external debt stock at around 220% of GDP and Iceland's net international investment position at a negative 52% of GDP. This compares favourably with a pre-crisis external debt of around 570% of GDP. However, Iceland's balance of payments situation remained sheltered by capital controls and external financing could become tighter once capital restrictions start to be lifted. Overall, recent estimates of Iceland's net international investment position suggest a much lower external indebtedness when compared to the pre-crisis period, but risks and vulnerabilities remain high with respect to Iceland's external financial position.

Table 2.1:
Iceland - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	6,0	1,2	-6,6	-4,0	2,6	2,4
Private consumption	Ann. % ch	5,7	-7,8	-15,0	0,0	2,7	4,1
Gross fixed capital formation	Ann. % ch	-12,2	-20,4	-51,4	-8,6	12,8	20,4
Unemployment	%	2,3	3,0	7,2	7,5	7,1	7,2
Employment	Ann. % ch	4,5	0,7	-6,1	-0,3	0,0	1,0
Wages	Ann. % ch	9,0	8,1	3,9	4,8	6,8	10,4
Current account balance	% of GDP	-15,7	-24,6	-11,6	-8,0	-7,0	-7,7
Direct investment (FDI, net)	% of GDP	-16,5	30,5	-18,2	20,7	8,4	20,8
CPI, average	Ann. % ch	5,1	12,7	12,0	5,4	4,0	6,1
Interest rate (3 months)	% p.a.	14,28	15,84	11,28	6,79	4,26	5,10
Stock markets	Index	7.017	3.510	465	563	602	649
Exchange rate ISK/EUR	Value	87,66	127,58	172,15	161,62	161,20	163,02
Nominal eff. exchange rate	Index	186,4	135,2	98,1	100,0	100,0	96,7
General government balance	% of GDP	5,4	-13,5	-9,9	-10,1	-5,4	-2,5
General government debt	% of GDP	28,6	70,5	106,6	124,3	98.8f	N.A.

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment remained close to historically high levels for the country, at 7.1% in 2011, though somewhat lower than the 7.5% recorded a year before. The drop was mainly due to labour market exits rather than job creation. Employment levels remained unchanged from 2010, but the share of full-time employment increased. During the first half of 2012, labour market conditions gradually improved. The unemployment rate was recorded at 7.2%, a significant improvement compared to the rate of 8.2% in the same period of 2011. The level of total employment rose by about 1% year-on-year. Data on registered unemployment confirm positive trends in early 2012. The registered rate fell to 4.4% in July, the lowest rate since December 2008, and the average unemployment rate in the first seven months was 6.2%, compared to 7.8% a year before. At the same time, the high and increasing rate of long-term unemployment (27% of total unemployed in 2011) remains a particular concern. Also, the youth unemployment rate remained high at 16% in 2011 and 17.1% in the first quarter of 2012. Despite high unemployment, the annual average gross wage growth increased by 2 percentage points to 6.8% in 2011, and further accelerated to close to 10% in the first seven months of 2012. Average real wage growth increased from 2.8% in 2011 to 4.0% in the first seven months of 2012. Overall, amid some recent stabilisation, the labour market remains affected by the post-crisis recession with high unemployment rates for the country, particularly among youth and long-term unemployed.

The Central Bank of Iceland continued to officially operate under an inflation targeting regime to keep consumer price inflation under 2.5% with a tolerance band of 1.5% in both directions. After annual inflation had fallen below the Central Bank's inflation target in early 2011, a weaker exchange rate, rising oil, house and food prices and higher wages pushed inflation to 5.3% by end-2011, exceeding the upper band of the inflation target. Inflation accelerated further in the first four months of 2012, but since then the rate has gradually fallen to 4.1% in August. In reaction to rising inflation in 2011 and early 2012, monetary policy has been gradually tightened since August 2011. The key policy rate (7 day collateralised lending rate) has been increased in five successive steps to 5.75% in June. Since the crisis, exchange rate stabilisation remained an intermediate objective of monetary policy, supported by a regime of capital controls. Seasonal effects have remained relatively strong on the Icelandic króna due to the capital controls and the importance of the fishing and tourism sectors for currency flows. The Icelandic króna depreciated in the first months of 2012 in line with the usual seasonal patterns and driven by the decision of some large domestic firms to pay down foreign-denominated debt. In reaction to unusually strong foreign exchange outflows, the Central Bank intervened in the foreign exchange market for the first time since 2009, selling € 12 million in March. Since May, the króna gradually recovered and appreciated relatively strongly by some 11% by mid-August, mainly due to inflows from tourism, a strengthening of capital controls, and a lower accumulation of reserves for debt service payments by market participants. The strong appreciation let the Central Bank to announce at end-July to double its weekly purchases of foreign exchange to € 1 million from each market maker. Under the current policy framework, while exchange rate risks appear limited over the short term, they could become more prominent in view of the need to gradually liberalise capital movements. Overall, a recently tighter monetary policy stance has supported a gradual lowering of inflation and exchange rate stability has been broadly preserved under the cushion of capital controls.

The authorities continued to implement the first steps of the capital liberalisation strategy which essentially aims to transform the large stock of non-resident króna holdings, mostly short-term deposits and government-guaranteed bonds into long-term domestic investments. These holdings are estimated at 25% of GDP, but may increase substantially as the old failed banks are being wound up. In a first phase, under way since May 2011, the Central Bank organised auctions to purchase króna from non-residents and auction them to investors willing to buy long-term government bonds or other domestic assets and hold them for a minimum of five years. It conducted a number of auctions resulting in a minor decrease of off-shore holdings, which fell by less than 10% of the initial estimated stock. A second phase started in November 2011, enabling investors to purchase half of the króna required to perform their investment through auctions, and to finance the remainder on the Icelandic financial market (50/50 option). Once the off-shore holdings are significantly reduced, liberalisation of capital controls on residents is envisaged. Following an extension of the capital controls until the end of 2013, rules were tightened in early 2012 to eliminate loopholes, remove exemptions on some bond payments and regulate payments made by the estates of the old banks. The Ad Hoc Group on the Removal of Iceland's Capital Controls set up by the Icelandic government and the European Commission met in September 2012 to assess the state of play, prospects and challenges associated with lifting the existing controls. Overall, implementation of Iceland's strategy for lifting of capital controls has progressed slowly and with limited success.

Fiscal consolidation continued in 2011, with significant cuts in current and capital spending and increase revenues through higher capital income, net wealth and inheritance taxes and a new bank levy. These measures helped reduce the general government deficit from 10% of GDP in 2010 to 5.4% in 2011. The deficit target of 3.4% of GDP was missed, largely due to the activation of government guarantees. Moreover, some fiscal slippage occurred as a result of the government's decision to contribute to the collective wage agreement by raising current spending. The 2012 budget targets a reduction of the general government deficit to 1.4% of GDP. It includes new consolidation measures of around 1.7% of GDP with most of the adjustment on the revenue side (1.2% of GDP). Expenditure restraint measures are projected at 0.5% of GDP, encompassing cuts in current expenditure and transfers and in investment. Fiscal performance during the first half of 2012 saw a solid 11% year-on-year rise in general government revenues, the strongest increase since 2007. This resulted mainly from higher receipts from income taxes and —to a lesser extent— taxes on goods and services. Compared to initial plans, some fiscal loosening continued on the expenditure side, estimated at 0.5-1% of GDP. Total spending rose by around 6.6%, encompassing all main components of current spending and a particularly strong increase in wages and debt service costs. Public investment spending continued to decline, by around 9% year-on-year. The deficit in the first half fell to 2.5% of GDP (or 1.2% of projected annual GDP), compared to 4.1% in the first half of the previous year. Overall, amid a successful process of fiscal consolidation, the adjustment of government finances has recently slowed.

Fiscal risks remain significant. Implementing expenditure restraint has become more challenging following years of fiscal adjustment and new expenditure pressures appear to be mounting. Weaknesses in Iceland’s budgetary framework still hinder effective control of spending by government agencies. The authorities have prepared and launched consultations on a draft organic budget law which aims to improve budget preparation and execution, broaden the coverage of fiscal reporting, and increase the government’s accountability to the Parliament. Risks remain linked to contingent liabilities in the form of government guarantees for public companies. The government’s expressed commitment to further strengthen the capital base of the State Housing Financing Fund implies a considerable fiscal effort, estimated at around 1% of GDP. In view of the high level of public debt, fiscal space remains very limited. Moreover, capital controls have provided public finances with the benefit of artificially lower interest rates than could otherwise be expected in view of the level of indebtedness. Overall, fiscal risks remain high and expenditure-based fiscal consolidation a particular challenge.

Gross general government debt increased from 88.1% of GDP in 2009 to 98.7% at end-2011 and debt levels remain high compared to pre-crisis levels of around 30%. Further progress has been made in professionalising medium-term public debt management. The average maturity profile of the public debt portfolio was extended to over 4 years, reducing rollover risks. The new Medium-Term Debt Management Strategy (2012-2015) published in March 2012 confirms the authorities’ commitment to reduce central government debt to below 75% of GDP by 2015 and to below 60% in the long term. Comprehensive legislation to strengthen local government finances was adopted, stipulating strict limits on municipal borrowing. Overall, in view of the high level of public debt, the authorities have taken further welcome measures to reduce refinancing risks and to strengthen local government finances.

The policy mix with a strong focus on exchange rate stabilisation, fiscal consolidation, and domestic debt restructuring has been supportive in re-establishing a higher degree of macroeconomic stability, but risks and vulnerabilities remain. Annual Inflation remains still above target and inflation expectations have apparently not come down. Fiscal risks are elevated and preserving exchange rate stability remains challenging, all in all requiring a rather tight policy mix. Implementation of the 2012 budget and medium-term fiscal plans will remain a key test for the government’s commitment to continued fiscal adjustment. Macroeconomic stabilisation occurred in a situation of protection through capital account restrictions. Their gradual removal remains a key policy challenge.

Interplay of market forces

Prices of goods and services continued to be mostly determined by supply and demand conditions except in agriculture where the level of import protection remained high. The private sector accounts for nearly 80% of GDP. Some sectors remain in government ownership, such as energy, postal services and broadcasting. The state owns the Housing Financing Fund and retained majority ownership (81%) of one of the three commercial banks (Landsbankinn) and minority stakes in the other two banks. It has also kept its position as a large investor in the savings banks system, although the importance of the system has declined significantly with the exit from the market of the two largest savings banks. There are currently no plans to transfer public ownership in those sectors to private investors. Overall, market mechanisms are to a large extent driven by free prices. Public ownership remains significant in some sectors and there are no plans for privatisation.

Market entry and exit

The business environment remained characterised by low bureaucratic hurdles and a generally efficient administration. Starting a business is facilitated by a supportive regulatory framework. High barriers to entry continue to exist in fishing, agriculture and energy, which are not covered by the EEA Agreement. The economic recovery has recently led to the revival of company start-ups. The number of newly registered private limited companies increased by 8.8% in the 12 months to July 2012, following a 23% drop in the preceding 12 months when potential businesses were still harshly affected by the strong recession. However, total registrations remained at around two thirds of pre-crisis levels. Bankruptcy proceedings are generally straightforward. The crisis put a large part of the corporate sector under severe financial distress and insolvency levels in 2011 were still twice as high as pre-crisis levels. In the twelve months to July 2012, the number of insolvent companies dropped for the first time after the crisis, by close to 5%, but was still one third higher compared to pre-crisis levels, suggesting on-going adjustments and deleveraging. Overall, high barriers to market entry for non-residents remain in key strategic sectors. Market exit has been functioning well, supporting economic adjustment.

Legal system

The legal system continued to support a business-friendly investment climate. It offers good protection and enforcement of property rights and provides a clear and stable framework for agents to take economic decisions in a situation of legal certainty.

Financial sector development

The restructuring and recapitalisation of the core banking sector has been largely completed even though further operational and financial restructuring is required to allow bank lending to resume. The number of banks decreased from 22 prior to the crisis to 14, and banks are solely operating domestically. The three largest commercial banks together with the Housing Financing Fund represent a market share of 94%. Private sector deleveraging and bank balance sheet repair continued through 2011 and the first half of 2012, and the private sector credit to GDP ratio dropped further to an estimated 88% of GDP, from 90% at the end of 2010, reflecting continuing adjustment to deal with past excessive imbalances. The government retains majority ownership of one of the banks, and minority stakes in the other two banks, with the majority stakes (indirectly) owned by non-residents. The total capital adequacy ratio of the three banks increased to 23% in the first half of 2012 from 22.1% a year before, well above the minimum requirement of 16%. All banks remained profitable with returns on equity at 11.5% in the first half of 2012, down from 16% a year before, but banks carry relatively high cost-to-income and cost-to-asset ratios. Also, the Supreme Court’s February 2012 judgement on the settlement of illegal exchange rate-linked loans could significantly impact on the quality of banks’ balance sheets and reduce future profits. However, the Financial Supervisory Agency expects a limited impact, not least due to relatively high capital buffers. Finally, interest rates on deposits remain distorted by capital controls, providing a competitive advantage to domestic banks that will disappear once restrictions start to be lifted.

Banks are faced with significant vulnerabilities as asset quality is subject to considerable uncertainty and financial imbalances are likely to persist for some time. Debt restructuring continued and led to more manageable domestic debt positions. Household debt fell further to 110% of GDP by March 2012, down from a peak of 130% in 2009. Corporate debt declined to 194% of GDP, after peaking at 380% at end-2008. However, private debt levels still remain among the highest for industrial countries and private households and businesses are still operating under significant financial constraints. The share of non-performing loans continued to decrease significantly from 40% at end-2010, but remains high at 23% (end-2011) and above 20% (mid-2012) , and defaults continue to be widespread. Open foreign exchange positions of banks decreased following the earlier Supreme Court judgment on the illegality of foreign currency indexation of some loans and the subsequent transformation of the relevant loans into domestic currency loans. But legal uncertainty for some loan classes persists, adversely affecting their value. On the funding side, banks continued to rely mainly on domestic deposits, since foreign direct investment and access to foreign credit remained limited, except for the sovereign. Prescribed liquidity requirements remained over-fulfilled through 2011 by a large margin. Savings remained locked by capital controls, facilitating banks' domestic funding. Overall, banking sector and debt restructuring continue to progress, but significant uncertainties remain with respect to banks' asset quality.

Further progress has been made in strengthening bank regulatory and supervisory practices, including the creation of a framework for effective coordination between the Central Bank and the supervisory authority (FME). A Basel Core Principles Assessment of Effective Bank Supervision was concluded in mid-April 2012. On this basis, the FME has developed a two-year action plan to address remaining supervisory gaps. New risk management tools are being introduced. Supervision needs to be further strengthened to bring it in line with international best practice and to close supervisory gaps.

The non-banking financial system comprises the government-owned Housing Financing Fund, pension funds, insurance companies and mutual, investment and institutional funds. The government injected € 206 million into the Housing Financing Fund in 2011 to raise its capital to just above 2% of risk-weighted assets, still far below the 5% long-term target. However, the capital adequacy ratio dropped again in the first half of 2012, to 1.4% as a result of continued losses from operations. The government expressed its commitment to strenghten the Fund's capital base to the regulatory target as soon as clearer evidence exists on the losses resulting from the private sector debt restructuring process. The authorities also started work on a comprehensive review of the Fund's operations and its position in the restored Icelandic financial system, expected to be finalised by end-2012. Overall, a number of steps have been taken to restore the non-banking financial sector; an overhaul of the Housing Financing Fund's operations remains a challenge in view of reducing the government's contingent liabilities.

Domestic equity markets continue to play a much smaller role in financial intermediation than before the crisis. Turnover in the equity market in the first four months of 2012 remained broadly unchanged from the same period a year before while the stock market index increased by 19%. The total market value of all listed shares remains at only around 20% of GDP (mid-2012) compared with a pre-crisis level of around 120% of GDP. The bond market, on the other hand, recovered its trading volume and reached pre-crisis levels. The market continues to be dominated by government and government-guaranteed bonds. Overall, domestic financial markets have somewhat recovered on the back of a more lively bond market while equity markets remain shallow.

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

Existence of a functioning market economy

The country's economy continued to recover from the long and severe post-crisis recession. Private sector debt restructuring made further progress, generally improving the financial positions of household and firm, conducive to macro-financial stability. The authorities expect the debt restructuring process to be completed by end-2012, although a large number of private sector balance sheets remain vulnerable. Efficient allocation of resources is still impeded in parts of the economy, due to financial sector vulnerabilities, extensive capital restrictions, and high barriers to market entry in some sectors. Overall, improving the functioning of financial markets and reducing barriers to market entry in some sectors remains a particular challenge.

Human and physical capital

The economic crisis severely affected the labour market. The labour participation rate fell further in 2011, to a historical low of 80.4% (compared to a pre-crisis level of 83.3%), but remains nonetheless high in international comparison. The share of employment in part-time work dropped to 24% (from 27% a year before) and total average working hours per week rose to 40 (from 39 in 2010). Outward migration may have prevented the unemployment rate from rising even faster, but net migration could entail a loss of skills. Net migration however has declined substantially since 2009. The structure of unemployment remains problematic with youth and low-skilled workers representing large shares of the unemployed.

The share of youth neither in education nor in the labour force has risen significantly. Under these circumstances, efforts to offer retraining and education, active labour market initiatives and lifelong learning approaches continued, aimed at retraining and upgrading skills of the labour force. The government also introduced measures to grant all persons under the age of 25 access to free secondary education. Total education spending remained at around 7.8% of GDP in 2011, with private households bearing around 10% of total costs. Overall, with unemployment still very high for the country, human capital remains significantly underutilised. Newly introduced measures on education and vocational training are addressing some of these problems.

Abundant sources of hydro- and geothermal power attracted substantial foreign investment in the aluminium sector in the past. Although the financial crisis slowed down investment, several new projects are under preparation, but continued risk aversion in international capital markets seems to have delayed planned projects. The share of investment in GDP reached a historic low at 12.9% in 2010 and increased somewhat to 14.1% in 2011, but still remained markedly below the long-term pre-crisis average of 22%. At the same time, the fall in real-estate activities and construction reflects some normalisation following earlier ‘boom’ year excesses. Public investment also fell, from a 3.7% of GDP long-term average to 2.2% in 2011. Net FDI inflows declined in 2011 but still remained rather strong at 7.4% of GDP, raising the total stock of inward FDI to around 95% of GDP, up from 85% a year before. Regarding future investment potential, Iceland is implementing a large-scale mapping exercise of energy resources, categorising them in areas for conservation and for exploitation. The results of this exercise were presented to the parliament in early 2012. Overall, the country continues to benefit from good basic infrastructure and abundant natural resources, suggesting significant potential for investment.

Sector and enterprise structure

Although new segments in manufacturing and services have expanded over the past years, in particular in some high-tech areas such as software, pharmaceuticals and biotechnology, the economy’s industrial sector continues to be characterised by a limited degree of diversification. The relatively small industrial sector (excluding construction), mainly aluminium manufacturing, represents roughly 9% of output and one fifth of employment. The share of construction in GDP has fallen markedly, from 11% in the boom year 2007 to approximately 4% of GDP in 2010 and 2011, reflecting adjustments in an over-leveraged sector and completion of large energy-related projects. The share of the service sector in total output declined somewhat in the context of the crisis, mainly due to reduced economic activity in the real estate, retail trade and financial sectors. However, services still account for two thirds of the economy and almost three quarters of employment. The importance of tourism and transport as a source of foreign exchange income has been steadily increasing, accounting for a quarter of total export earnings in 2011, a result of the 20% increase in foreign tourism income in 2011. The share of marine products and primary aluminium products increased to 80% of merchandise exports. The share of services, mainly travel and transport, remained fairly stable in 2011 at around 35% of total exports. The importance of small firms in the economy remains high, accounting for 70% of employment and output. Overall, post-crisis adjustment continued to impact the sector structure of the economy; in particular tourism and transport have gained in importance.

State influence on competitiveness

The level of state subsidies amounted to 1.7% of GDP in 2011, decreasing by 0.1 percentage points compared to 2010. The relatively small agriculture sector continued to benefit from government subsidies, import protection, and a system of production quotas. Certain industries such as energy and fishing remain protected from foreign ownership. The fishing industry does not receive any State support. The telecommunication sector is liberalised and privately owned while government interventions remain limited to infrastructure investments in remote areas. Overall, State interference remains significant in some areas including the banking sector.

Economic integration with the EU

Iceland is an open economy with total trade in goods and services representing around 108% of GDP. The country's export structure continues to show a low level of diversification. The import structure is more diversified, reflecting the country's dependence on a wide range of manufactured goods and some commodities. The EU continues to be the largest trading partner, although its share in Icelandic merchandise exports dropped somewhat to 75% in the first four months of 2012, compared to 81% a year before. Just over 40% of imports originate in the EU. FDI inflows originate almost exclusively originate from EU partner countries. Overall, integration with the EU in the areas of trade and investment remained high.

Rough estimates point to average labour productivity remaining unchanged in 2011 as compared to 2010. Thus, unit labour costs rose in line with total labour costs, increasing on average by around 6% in the manufacturing sector. In 2011, the exchange rate of the króna depreciated by 3.5% vis-à-vis the euro. It remained rather constant in nominal effective terms and recorded a slight appreciation in real effective terms, continuing the trend of the previous year. According to estimates, the real exchange rate remains around 20% below its long-term average. Overall, Iceland still benefits from strong price competitiveness vis-à-vis its main trading partners as a result of the marked depreciation of the króna during the crisis.

2.3. CONCLUSIONS

Following a long and severe recession, the Icelandic economy started to recover in 2011 and grew by 2.6% in 2011, and expanded at a similar rate in the first half of 2012. The authorities proceeded with domestic debt restructuring, financial sector stabilisation and fiscal consolidation. A second post-crisis international bond of US$ 1 billion was sold to foreign investors in May 2012 at a rate of 6%. Iceland regained investment grade by all three major rating agencies. Yet, weak financial and non-financial sectors' balance sheets still imply considerable risks to economic and financial stability. The removal of capital restrictions remains a key policy challenge.

As regards the economic criteria, Iceland can be considered a functioning market economy. However, financial sector weaknesses and capital movement restrictions still impede an efficient allocation of resources. Iceland should be able to cope with competitive pressures and market forces within the Union over the medium term, provided that it continues to address current structural weaknesses through appropriate macroeconomic policies and structural reforms.

The policy mix with a strong focus on exchange rate stabilisation, fiscal consolidation, and domestic debt restructuring has been supportive in re-establishing a higher degree of macroeconomic stability. Monetary policy has been tightened in reaction to rising inflation and exchange rate stability has been broadly preserved. Fiscal consolidation continued with additional revenue and spending measures in the 2011 and 2012 budgets. Measures were taken to reduce general government refinancing risks and to strengthen local government finances. A trade surplus and a roughly balanced underlying current account were maintained. A fall in the unemployment rate and recent growth of employment suggest that labour market conditions have improved somewhat. The country enjoys good basic infrastructure, abundant natural resources, and a flexible labour market with high participation rates.

However, macro-financial vulnerabilities remain significant. Annual inflation stayed above the target and inflation expectations are high. Preserving exchange rate stability remains challenging. Fiscal risks persist. Public and private debt levels remain high even after debt restructuring and private. Households and businesses are still faced with significant problems. Banks' asset quality is subject to large uncertainties and defaults continue to be widespread. Unemployment is still around 7%, which is close to unprecedented levels for the country. It particularly affects youth and includes a high share of long-term unemployed. Macroeconomic stabilisation occurs in a situation of temporary protection through capital account restrictions, which will have to be lifted. Growth, investment and development are hampered by high barriers to market entry in certain sectors. The industrial structure remains little diversified.

3. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

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

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

A broad consensus has been maintained on the fundamental features of the country's economic policy set-up. The medium-term policy framework was described in various programmes, such as the sixth pre-accession economic programme (PEP), covering the period 2012-2014, the labour market strategy for 2015 and the national employment action plan for 2011-2013. In addition, the authorities embarked on a high-level accession dialogue (HLAD) with the EU, which provided another platform for accelerating accession-related reforms in the economy. Cooperation with the IFIs, such as the World Bank and the IMF continued, although the IMF's second review of the current financial arrangement could not be completed yet. Structured dialogue with the business community continued. Overall, a broad political consensus has been maintained on the fundamentals of economic policy.

Macroeconomic stability

The economy grew by about 3% in 2011, but shrank by about 1% year-on-year in the first half of 2012, compared with growth of nearly 5% in the first half the year before. Rather resilient private consumption helped to prevent a sharper slowdown, while the reduction in public consumption had a negative contribution to growth. Indicators on domestic production point to a marked year-on-year deceleration during the reporting period, with industrial production being on average nearly 9% lower since October 2011 than in the same period the year before. Average per capita GDP improved in relation to the EU average, increasing from 35% of the EU average in 2010 to 36% in 2011. Overall, economic activity has decelerated since autumn 2011, although private consumption and investment remained rather resilient in view of the markedly weaker international environment.

External imbalances declined, but their financing deteriorated. In the first half of 2012, the current account deficit was at about -2.8% of the estimated full-year GDP, compared to -3.5% of GDP the year before. The most important factor for the improvement was a further increase of current transfers to about 10% of the estimated full-year GDP. The trade balance of goods and services deteriorated slightly, reaching 12% of estimated full-year GDP, compared to 11% of GDP the year before, mainly as a result of weaker export revenues. The capital and financial account surplus shrank to a similar extent, declining to about 2.6% of GDP by June 2012, compared to a surplus of 4% a year before. FDI inflows and other investment declined to about 1% of the estimated full-year GDP and 0.6% of GDP respectively, compared to 2% of GDP and 4% of GDP a year before. As a result, the financing of the current account deficit was less based on investment inflows but on external credits.

Gross external debt[1] rose slightly to 61.2% of GDP in the first quarter of 2012, compared to 59.7% a year before. The main reason for this increase was public external debt, which rose by 2.2 percentage points of GDP, while private debt declined by 0.7 percentage points. Foreign reserves stood at € 2.1 billion (about 30% of GDP) in July, compared with € 1.8 billion (29% of GDP) the year before. The

[1] Without taking into account repurchase agreements of the monetary authorities. With this transaction included, the gross external debt ratio rose to about 65% of GDP in the first quarter of 2012, compared to 61.5% the year before.

coverage of prospective imports by reserves improved slightly, reflecting not only an increase in the level of foreign reserves, but also expected lower imports. Overall, the current account deficit shrank. However, the financing of the deficit increasingly relied on foreign loans, leading to an increase in public gross external debt.

Table 3.1:
The former Yugoslav Republic of Macedonia - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	6,1	5,0	-0,9	2,9	2,8	-1,1
Private consumption	Ann. % ch	7,2	6,6	-4,7	1,3	4,0	1,9
Gross fixed capital formation	Ann. % ch	17,1	5,4	-4,3	-2,7	17,3	N.A.
Unemployment	%	34,9	33,8	32,2	32,0	31,4	31,4
Employment	Ann. % ch	3,5	3,2	3,4	1,3	1,1	-0,1
Wages	Ann. % ch	4,8	8,7	14,1	1,0	1,2	0,2
Current account balance	% of GDP	-7,1	-12,8	-6,8	-2,1	-2,7	-1,8
Direct investment (FDI, net)	% of GDP	8,5	6,1	2,0	2,2	4,0	2,7
CPI	Ann. % ch	2,3	8,3	-0,8	1,6	3,9	2,4
Interest rate (3 months)	% p.a.	5,60	5,30	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	6.971	5.149	2.497	2.472	2.407	1.988
Exchange rate MKD/EUR	Value	61,18	61,26	61,28	61,51	61,53	61,55
Nominal eff. exchange rate	Index	99,6	100,6	106,6	106,0	106,9	107.6*
General government balance	% of GDP	0,6	-0,9	-2,7	-2,5	2,5	-1,7
General government debt	% of GDP	22,7	20,7	23,8	25,8	28,3	N.A.

* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment was very high at 31.2% and remained largely unchanged year-on-year in the second quarter of 2012, while during winter it had been about 1 percentage point higher than in the year before. Employment was about 1% higher than a year before but its impact on unemployment was limited, as most newly employed persons appear not to have been registered in the labour market before. The main sectors with employment growth in the second quarter of 2012 were education, the textile industry and municipal services. Youth unemployment increased slightly, from 54.6% in the second quarter of 2011 to 54.9% in the second quarter of 2012. The young account for about 10% of the labour force, but their share in unemployment rose from 18.5% in the second quarter of 2011 to 18.8% in the second quarter of 2012. Unemployment among the less-well educated

[2], who make up nearly 30% of the labour force, has declined, from 39% in the second quarter of 2011 to 36% in the second quarter of 2012. Employment in the public sector increased by about 1% year-on-year, mainly in the education sector. However, as a share in total employment the share of public sector employment has declined from 22% in mid-2011 to 21% in mid-2012. Overall, the situation in the labour market remains weak. Unemployment continues to be very high, particularly among the young and less educated.

Monetary policy cautiously supported the gradual recovery, while the exchange rate policy remained geared to maintaining price stability and the de facto peg to the euro. The Central Bank has slightly lowered its key policy rate, from 4% to 3¾%. In order to support the lending activities of the financial sector, the Central Bank amended the rules on minimum reserve requirements and collateral. It also introduced a number of measures to stimulate financial market activity, such as establishing new monetary instruments, a new overnight deposit facility and a one-week deposit facility, a standing 7-day repo facility and by lowering the interest spreads between overnight deposit rates and Central Bank bills. Overall, the exchange rate and monetary policies have remained sound.

[2] Persons with less than three years of secondary education.

Inflation was markedly lower than a year before, with an average inflation in the first eight months of 2012 of 2.4%, compared to 4.4% the same period a year before. However, during recent months, inflationary pressures have increased. The main sources for the increase lie in higher energy prices, but also rising food prices and rent costs. Prices for food and beverages account for about 40% of the consumer basket. Core inflation, which excludes the impact of energy and food prices on the overall price level, remained fairly stable and below 2%.

The published central government deficit for 2011 was in line with the 2.5% of GDP target. Revenue, which accounts for some 30% of GDP, was some 7.5% lower than initially expected. In order to meet the deficit target, spending was reduced by about 7%, mainly on purchases of goods and services, which were kept some 19% below their initial budget target. Capital investment was also kept some 16% lower than originally planned. However, as a share of GDP capital spending rose, from 3.5% in 2010 to 3.8% in 2011, while overall spending declined from 32.0% of GDP to 31.2%. In 2012, revenues have so far remained below forecasts and dropped by 3% in real terms. To compensate for the shortfall, the authorities adopted a supplementary budget and raised the deficit target for 2012 from -2.5% of GDP to -3.5%. So far, the main area of spending cuts was again capital spending, accounting in July for about 1.8% of the estimated full-year GDP, compared to 2.4% a year before. In the first seven months of 2012, published data point to a deficit of about 2% of the estimated full-year GDP, which is a similar level as the year before. The government debt ratio rose to about 30% of GDP in July 2012, compared to around 25% the year before, mainly due to increased domestic lending. In spite of existing legal obligations, neither the fiscal and public debt strategy nor the Public Investment Programme have been updated yet for the period 2012-2014. Furthermore, the authorities did not submit a Fiscal Notification, which should present central government data in a format comparable to EU standards.

Fiscal decentralisation has continued. By mid-2012, 84 of the 85 municipalities had advanced to the second stage of decentralisation. Furthermore, municipalities' share of revenue allocation has increased. The efficiency of the local units in charge of financial management still needs to be strengthened by improving management and competences, by ensuring adequate staffing levels and shortening administrative procedures.

Fiscal policy remained geared to meeting the deficit target, although due to a weaker-than-expected revenue performance the fiscal target had to be raised in autumn 2012. Budgetary planning and execution have deteriorated and the quality of public spending continues to be low. The budgetary process continues to be plagued by overly optimistic revenue estimates, a lack of medium-term planning, short-term oriented spending decisions and a deterioration in public spending management, resulting in increasing payment arrears, a further reduced transparency of spending decisions and weakened reliability of public sector accounts. This not only blurs the information on the countries' fiscal position, but also has negative knock-on effects on the liquidity situation of the private sector

Overall, the policy mix continued to be directed towards stability. Monetary conditions were supportive to growth, while taking into account the country's policy of a de facto peg to the euro. Public spending was kept largely in line with revenue. However, budgetary planning and the management of public expenditure have deteriorated markedly and the quality of public spending has remained weak. Unemployment continues to be very high, in particular among the young, posing a persistent major policy challenge. Macro-fiscal risks are mainly related to external shocks, such as a further decline in external demand, higher import prices and/or a drop in current transfers.

Interplay of market forces

Privatisation is largely completed and the economy is mainly driven by market forces. The role of the private sector increased slightly from 82% of total value added in 2010 to 82.4% in spring 2012, mainly as a result of an increase in value added in construction and trade. The government took some decisions which increased the state’s role in the economy, such as agreeing to a debt-equity swap with a few troubled companies. At the same time, the government scheme to sell state land generated revenue, but also lowered the level of state assets. Attempts to privatise several state-owned companies failed. Overall, the asset value of fully or partly state-controlled property remains largely unchanged at some 13% of GDP. The majority of state capital — nearly 80% — is concentrated in five companies, mainly public utilities. The public sector employs some 20% of the labour force and public procurement accounts for about 11% of GDP. The share of administered and regulated prices in the CPI basket remained unchanged at 13.1%. Regulated prices, which account for about 12% of the CPI basket, usually cover costs. However the electricity prices are still distorted as a result of persistently high technical losses and non-cost covering input prices. Administered prices, such as for water supply and waste disposal which account for about 1.4% of the CPI basket, usually are not cost recovering. Overall, the role of the state has remained largely unchanged and limited.

Market entry and exit

The government has continued its efforts to facilitate market entry and exit. However, partly due to the less supportive international economic environment, the number of newly established companies has declined to slightly below 10% of the total number of enterprises. Limited access to finance is still impeding the growth of many companies, in particular of small and medium-sized enterprises (SMEs). The third phase of the ‘regulatory guillotine’ project, which focuses on reducing administrative burdens, is being implemented and the fourth phase, concentrating on measures for SMEs, has started. Further progress has been made towards closing down non-operating companies. In the period October 2011 and August 2012, the number of bankruptcy procedures was some 32% higher than a year before. The average duration of company liquidation has been reduced. Overall, some further progress was made on facilitating market entry and exit.

Legal system

The legal system for a functioning market economy is largely in place. Real estate property registration is practically completed. The authorities adopted a number of reforms to increase the efficiency and transparency of courts, and to expedite legal procedures. The number of pending commercial court cases declined, from 5,782 at the end of 2011 to 2,152 cases in mid-2012. The duration of court proceedings remained largely unchanged. About one third of the cases are resolved within three months and about 60% within six months. The share of cases taking more than five years fell further, from 1.2% in 2010 to 0.8% in 2011. Despite simplified procedures and introduction of new legal instruments strengthening payment discipline, contract enforcement is still difficult, hampering the business environment, in particular for SMEs. Sometimes, the legislative process suffers from insufficient discussion with the stakeholders, leading to the need of frequent revisions of recently adopted legislation. Implementation of existing legislation needs to be further strengthened.

The legal and financial independence and the resource endowment of some regulatory and supervisory bodies has been strengthened. However, in some cases such as the Agency for supervision of fully-funded pension insurances (MAPAS), the State Appeals Commission for Public Procurement and the State Commission for Prevention of Corruption, the endowment with human and IT resources and/or the leverage are still insufficient. The quality of the decisions of the Commission for Protection of Competition needs to be further improved. The follow-up of the State Audit Office (SAO), reports by the Parliament is inadequate and government mechanisms to deal with systemic shortcomings identified in SAO’s reports are lacking.

Overall, the functioning of the legal system has continued to gradually improve. However, weaknesses related to lengthy procedures, corruption and difficult contract enforcement are continuing to hamper the business environment.

Financial sector

The significance of the financial sector and its intermediation function have both improved further. Despite the international financial crisis, the sector's assets rose slightly from 71% of GDP the end of September 2011 to 72% at the end of June 2012. Deposits remained largely unchanged at about 50%. Gross loans rose from 44% of GDP to 47%, mainly due to increased lending of medium-sized banks. Deposits remain the sector's main source of liquidity, covering more than 112% of outstanding loans. The sector continues to be owned predominantly by foreign companies, with 13 out of 17 banks dominated by foreign owners. The share of foreign ownership rose to 75% of GDP in mid-2012, compared to 73% a year before. The share of state ownership in the sector remains low, at some 7% of the sector's assets. The main state assets in this sector are still its majority share in the country's only development bank and a limited number of remaining minority shares. Market concentration remains high, but decreased slightly. The assets of the five biggest banks in terms of their share of total assets declined slightly, from 67% in mid-2011 to 66% in mid-2012. The efficiency of the banking sector has improved slightly. The profitability of the sector as a whole recovered slightly in the second quarter of 2012. Credit growth has recovered since autumn last year, reaching some 8.5% in the first seven months of 2012. Private-sector weighted lending rates declined to some 8.4% in July, while deposit rates dropped slightly faster, to some 5%. As a result, spreads widened slightly to 3.4 percentage points. Financial stability has been maintained, with sound liquidity, solvency and capital adequacy ratios. The share of non-performing-loans increased slightly in the case of large and small-sized companies, while in the group of medium-sized banks, the loan performance improved. The sectors average ratio of non-performing loans remained close to 10% with provisions still exceeding the amount of identified non-performing loans.

Banking regulation and supervision are largely in line with international standards. The relevance of non-banking financial market intermediaries continues to be limited, with assets equivalent to some 10% of the financial sector's assets or around 8% of GDP. Insurance institutions account for some 4% of the sector's assets and leasing companies and pension funds for about 3% each. The value of the capital market accounts has continued is decline to about 30% of GDP.

Overall, the trend towards further deepening and widening of the financial sector continued. However, the levels of financial intermediation and competition in the market are still low, constraining more dynamic growth in the private sector, particularly for SMEs. Furthermore, some regulatory and supervisory agencies continued to be impeded by insufficient levels of resource endowment and leverage.

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

Existence of a functioning market economy

Overall, macroeconomic stability has been maintained. Market entry and exit procedures have improved. Some steps have been taken to strengthen the rule of law. However, so far, those measures have not had significant impact yet. The quality of public finance planning and management has deteriorated and the quality of spending has remained low. Unemployment remains very high, particularly among the young. The business environment continues to suffer from institutional and administrative weaknesses, difficult contract enforcement and corruption.

Human and physical capital endowment

The level of human capital endowment is still low. The authorities continued to improve the physical infrastructure for education, to increase the numbers of teachers and to modernise the curricula. The number of teachers rose by 1.5% in the school-year 2011-12, after an increase by 4.4% the year before. As in the previous year, the increase was mainly due to additional recruitments in primary and lower-secondary schools. Measures have been taken to raise enrolment rates, although in some areas this policy faced difficulties. Budget allocations for education rose marginally in 2011, from 4.6% of GDP in 2010 to 4.7% of GDP, while for 2012 the budget envisages a decline to 4.5% of GDP. Despite continued efforts, the overall level of education of the labour force is still relatively low and the mismatch of skills is still substantial. There is significant room for improving the efficiency of public spending on education and for raising the quality of education. Overall, measures to improve qualification levels have continued. However, the still low level of education calls for further sustained efforts in order to improve the country's human capital endowment.

The country's capital endowment remains relatively low and its quality is hampered by decades of underinvestment in the past. Public investment increased to some 3.8% of GDP in 2011. However, there is very limited information on the actual spending priorities. Gross fixed capital formation was still high at some 36% of GDP in the last quarter of 2011, but dropped to 22% in the first quarter of 2012. The authorities do not provide recent disaggregated gross investment data, which would allow a better understanding of the driving factors behind the investment decisions. Some limited steps have been taken to improve the country's transport infrastructure. The stock of foreign investment increased from 51.5% of GDP in mid-2011 to 53% in mid-2012. Overall, spending on strengthening the knowledge-based economy has remained low. The efforts to increase the public capital stock continue to be impeded by weak implementation capacity, but also by use of funds for less productive purposes, such as the decoration of the capital. Overall, the country's capital stock remains low.

Sectoral and enterprise structure

There were no major changes in the area of restructuring enterprises. Network industries are dominated by a very small number of incumbent suppliers, which often undermines effective competition. SMEs continue to be by far the biggest group of companies, providing more than 80% of private-sector employment or nearly 60% of total employment. Access to finance improved, partly thanks to additional international credit facilities, primarily provided by the European Investment Bank (EIB). Furthermore, the government continues to subsidise interest costs for SME loans, although on a declining scale in the 2012 budget.

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

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

State influence on competitiveness

The overall level of systematic state intervention is limited. The data available suggest a relatively low level of State aid, i.e. less than 1% of GDP. However, this figure is not comparable with the State aid data compiled in accordance with EU standards. The Competition Commission is in place. However, the quality of its decisions should be further improved and the reporting awareness of state-aid providers is not sufficiently developed. Overall, state influence on competitiveness remained limited.

Economic integration with the EU

The country is a small, open economy, with total trade in goods and services accounting for about 120% of GDP in 2011. Trade integration with the EU is advanced. About 64% of all exports currently go to the EU-27 and about 56% of imports originate there. The country's second largest trading area is the CEFTA, which accounts for around 24% of exports and around 11% of imports. The export structure has improved, with an increase in the share of higher unit-value commodities, such as car emission catalysts. However, textiles, clothing and manufactured iron products still account for more than one third of total exports. FDI accounts for about 50% of GDP, with 80% of the investment stock coming from the EU. The exchange rate against the euro has remained stable in nominal terms. Price competitiveness has remained largely unchanged. This is reflected in the largely unchanged real effective exchange rate, which in mid-2012 was some 1% lower than a year before. Overall, trade integration with the EU is well advanced. The commodity composition of exports has improved, although traditional products, such as textiles, clothing and steel, still predominate. International price competitiveness remained largely unchanged.

3.3. CONCLUSIONS

The economy of the country continued growing at a decelerated pace in 2011, but declined in the first half of 2012. Growth was based on resilient domestic demand, while external demand has been declining. Structural reforms have continued, but overall at a slow and gradual pace. There has been some further progress in simplifying business registration, accelerating judiciary procedures and deepening financial intermediation. However, little has been achieved in addressing the very high unemployment, which is mostly structural and affects mostly the young and poorly educated.

As regards the economic criteria, the former Yugoslav Republic of Macedonia continues to be well advanced. In some areas, it has made further progress towards becoming a functioning market economy. The country should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it vigorously implements its reform programme in order to reduce significant structural weaknesses.

The country has maintained a broad consensus on the essentials of economic policies. Monetary policy, based on the de facto peg to the euro, contributed to macro-economic stability. Fiscal policy kept spending largely in line with revenue growth. Privatisation is mainly completed. Price and trade liberalisation has been largely accomplished. Some further progress has been achieved in facilitating market entry and in simplifying the regulatory framework. The judiciary procedures accelerated with the average duration of bankruptcy procedures further reduced. Property registration is practically accomplished. The financial sector so far weathered the financial market turbulences rather well and maintained its trend towards increased intermediation and market deepening. Gradual progress in the education sector has continued. Increased FDI helped to diversify the country’s export structure.

However, the quality of fiscal governance has deteriorated further; medium-term planning and public expenditure management has worsened, and the transparency and reliability of public sector accounts declined. Furthermore, the short-term orientation on spending with low growth enhancing effects has continued. Public sector debt has increased significantly. Unemployment remained very high. The functioning of the labour market is impeded by structural weaknesses. The level of education and qualification of the human capital is low. Similarly, the physical capital needs modernisation and deepening. Despite gradual improvements, the functioning of the market economy continues to be impeded by institutional and judiciary weaknesses. Some regulatory and supervisory agencies still lack the necessary resources and leverage to fulfil their functions effectively. The capacity and efficiency of public administration in providing services to businesses requires improvement. The informal sector remains an important challenge.

7. MONTENEGRO

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

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In January 2012 the country presented its first Pre-accession Economic Programme (PEP), covering the period 2012-2014. The priority of the programme is to reinforce economic and financial stability by continuing with fiscal consolidation and structural reforms. Overall, the political consensus on market economy fundamentals and economic policy remained strong.

Macroeconomic stability

The economy continued to recover in 2011 for a second consecutive year, with real GDP growing at a similar growth rate as in 2010 (at around 2.5%). In 2011 the recovery was primarily driven by private consumption fed by continued increases in tourism, whereas the contribution of net exports to growth dropped significantly, reflecting import developments and the recovery of commodities exports. Retail sales increased by 15% at constant prices, reflecting demand from tourism. Nonetheless, domestic demand still remained constrained as bank lending further contracted, investments slowed down, employment growth remained limited, and net wages rose only marginally. In the first half of 2012, economic activity slowed down. The value of construction works contracted in real terms by 16% year-on-year in the first half of 2012, after recording an average expansion of 7% in 2011. Industrial output declined by 7.5% year-on-year in the first six months of 2012, due to a decrease in electricity production and mining , while manufacturing recorded 4% expansion. Still, domestic consumption continues to be resilient, as reflected by the increase in retail sales by 9% in real terms in the first half of 2012, once more supported by tourism. Average per-capita income in purchasing power standards rose to 43% of the EU average in 2011, up from 41% in 2010. Overall, although the economy is still in the process of recovering, the performance of several sectors remains weak.

The current account deficit contracted to 19% of GDP in 2011, compared to 25% a year earlier. The improvement was driven by an increase in the surplus of the balance of services from 13% of GDP in 2010 to 16% in 2011. However, the trade deficit still accounts for 40% of GDP. The income balance shifted from a deficit to a surplus, while current transfers improved marginally. On the financial account, net FDI inflows contracted markedly, totalling 12% of GDP, compared to 18% a year before. As a result of lower net capital inflows, the central bank had to use foreign exchange reserves equivalent to 3% of GDP to finance the high current account deficit, underlining vulnerabilities related to the high reliance on external financing. In the first half of 2012 the trade deficit deteriorated following a sharp decline in exports as a result of the contraction of industrial production as well as terms of trade losses in aluminium, causing an 8.7% year-on-year expansion of the current account deficit to 14.5% of annual GDP. The surpluses in the services and current transfers' balances improved significantly compared to the previous year, but were partially offset by the negative results in the income balance. The financial account surplus contracted by 9% year-on-year while the capital account deficit came close to balance. Net FDI inflows contracted to 4.3% of annual GDP from 5.6% a year earlier while net loans inflows (i.e. other investments) reached 3% of GDP, largely reflecting government financing operations. Net errors and omissions accounted for additional 6% of GDP. Overall, the large external imbalances deteriorated, reflecting weak export capacity.

Table 4.1:
Montenegro - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	10,7	6,9	-5,7	2,5	3,2	-0,9
Private consumption	Ann. % ch	N.A.	N.A.	-7,7	4,2	0,0	N.A.
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	-25,3	-21,2	-0,1	N.A.
Unemployment	%	19,3	16,8	19,1	19,7	19,7	20,0
Employment	Ann. % ch	3,7	2,1	-3,7	-2,0	-6,4	-1,0
Wages	Ann. % ch	14,2	22,8	5,7	11,0	1,0	0,8
Current account balance	% of GDP	-39,5	-50,6	-29,6	-24,7	-19,6	-20,7
Direct investment (FDI, net)	% of GDP	21,2	18,9	35,8	17,5	12,0	10,5
CPI	Ann. % ch	4,3	7,4	3,4	0,5	3,1	3,4
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	2,27	5,32
Stock markets	Index	36.117	20.009	13.316	14.003	11.889	9.216
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	6,2	-0,4	-5,7	-4,9	-5,4	-3,7
General government debt	% of GDP	27,5	29,0	38,2	40,9	45,9	47,9

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment was very high at 20% on average in 2011 and in first half of 2012, according to the Labour Force Survey (LFS) Although employment declined markedly by -6.4% in 2011 compared to the previous year, the rate of contraction decelerated in the first half of 2012 (0.9%). The activity and employment rates remained low at around 57% and 46% respectively during 2011 and the first half of 2012. There remain significant discrepancies in labour statistics between Labour Force Surveys (LFS) and the Agency for Employment (AEM) administrative records. Slow labour market dynamics have been reflected in the moderation of wages. In the first half of 2012 the average gross wage grew by nominal 0.7% year-on-year. In December 2011, amendments to the labour law introduced several changes with the aim of encouraging job creation. These amendments limit the length of fixed-term contracts to 24 months, and put an end to the possibility of an unlimited number of renewals. They regulate temporary employment agencies. They also reduce collective dismissal costs and limits the room for discretionary labour dispute resolution. Additional amendments were introduced in the law on employment of foreigners and disabled persons to facilitate their hiring. Also in December, the parliament adopted the laws on recognition of foreign professional diplomas and qualifications. Overall, the performance of the labour market remained weak.

Unilateral euroisation implies that there is limited scope for monetary policy discretion. Changes in reserve requirements remained the key tool for steering liquidity in the system. In November 2011, the central bank further lowered the reserve requirement ratios to 9.5% for deposits with maturity of up to one year, and to 8.5% for deposits with maturity over one year.

Inflation reached 3% in 2011, a significant increase after a deflationary episode in 2010. However, core inflation remained low, at around 1%. Consumer price inflation accelerated to 3.9% in June 2012. The main contributors were alcohol and tobacco reflecting a pronounced base effect from the increase in excises duties at the beginning of the year. Increases were also recorded in accommodation services (i.e. restaurants and hotels), food, as well as fuels and housing, the latter as a consequence of the increase in water supply prices and electricity tariffs. Overall, inflationary pressures have been increasing.

In 2011, the consolidated budget deficit reached 5.4% of GDP, up from the 5% deficit recorded the previous year. Total revenues fell to 39% of GDP in 2011, down from 42% a year earlier. Tax income remained broadly stable in 2011, with the corporate income tax and value added tax revenues recording some moderate growth over the year. However, social security contributions declined and the accumulation of tax arrears reached almost 1% of GDP during 2011, weakening revenue performance. Consolidation efforts translated into a reduction of general government expenditures to 44.6% of GDP, compared to 47.2% the year before. Spending was reduced on several items such as supplies and services, as well as on regular maintenance and capital expenditure. However, the impact of early retirements granted to workers from restructured companies offset efforts to cut expenditure. Further revenue shortfalls in the first quarter of 2012 (around 12% lower than to the same period last year), followed by the call of a state guaranteed loan to the aluminium plant worth 1% of GDP, resulted in a budget deficit of 3.2% of GDP in April, compelling the government to adopt a budget rebalance in May. The revised 2012 budget comprises additional expenditure cuts of 0.3% of GDP and tax increases for additional 0.7% of GDP. The budget deficit broadened further to 3.5% of GDP in May, to stabilise at 3.7% in both June and July. Overall, the stability of public finances is challenged by a receding economy and substantial contingent liabilities.

Contracting external demand, falling aluminium prices as well as production, and lower capital inflows have exposed the country to stronger external financing and liquidity constraints. The fact that Montenegro is using the euro as its sole legal tender, and has therefore abandoned standard monetary policy tools, leaves fiscal policy as the main effective policy instrument. As a response, the authorities have continued to aim at tightening fiscal policy, notably through public spending adjustments. Overall, macroeconomic stability has been broadly maintained, but risks and uncertainties persist due to the high reliance on external financing.

Interplay of market forces

The share of administered prices in the harmonised index of consumer prices (HICP) basket remained unchanged in 2011, at 10.7%. Administered prices concern: bread, electricity, water supply, sewerage collection, refuse collection, fuels, public pre-primary institutions, compulsory vehicle insurance and administrative fees. The telecommunications and energy markets were further liberalised. At present, the Agency for Electronic Communications and Postal Services (EKIP) can regulate prices only if a company has a dominant market position. The energy regulator no longer sets the price of coal for electricity generation. Overall, the influence of the state in price dynamics is being limited by the independence of market regulators.

In April 2012 the Parliament requested the government to renationalise the ailing aluminium company and to execute the collateral of a state guaranteed loan after the majority owner of the company failed to honour it. However, at the time being the execution is being delayed. At the same time, the bankruptcy of the Niksić steel plant ended with the successful sale of all the factory assets (including 21.9% of state-owned shares) to a Turkish steel maker. Several transport companies, including railways, port and the national airlines have been listed in the privatisation plan for 2012. In the first half of 2012 calls for tenders were launched for the tobacco factory (NDKP), the Institute for Physical Therapy, as well as the container and bulk cargo terminal of the port of Bar. In July 2012, the privatisation council concluded a 90-year lease contract to develop a tourism resort on the former barracks site of Kumbor (Kotor Bay). However, negotiations on the sales agreement for newspaper Pobjeda and for dairy Zora are not yet concluded. Overall, the privatisation process resumed after two years of stagnation.

Market entry and exit

In 2011 there were 3,072 new enterprises registered in Montenegro, or 17% less compared to 2010. The pace of registration recovered during the first half of 2012, totalling 1,948 new businesses. The procedure for electronic registration of companies through the eGovernment portal became operational in May 2012 and the application of the regulatory guillotine further pursued. Line ministries started in mid-2012 monitoring the implementation of amendments to or revocation of parts of the legislation identified in the regulatory impact assessments as creating barriers to businesses. Credit constraints and the slow and lengthy process of granting municipal licences still hamper investment prospects and delay the establishment of new businesses. The number of bankruptcy cases has fallen significantly to 565 in 2011, compared to 2,196 a year before, although reaccelerated to 824 in the first half of 2012. Overall, while some improvement has been recorded in market entry procedures and bankruptcy recovery, further efforts are still required to facilitate municipal licences.

Legal system

In December 2011, the parliament enacted the Law on Public Bailiffs, transferring powers for the civil enforcement of commercial contracts to these new legal officers. However, enforcement of civil decisions remains weak and bailiffs are yet to be recruited. There have been no further legislative developments in the field of property rights after the adoption in June 2011 of the Law on State Surveying and the Land Registry. The modernisation of the land registry's current electronic system continues. Although the strategic and legislative framework to combat corruption has been strengthened, its implementation remains uneven. In order to address weaknesses in tax as well as in law enforcement, the government adopted in May 2012 a series of measures to combat the grey economy, increasing the number of inspection controls, notably on excise products, retail turnover accounts, and labour market registration. As a result, in May and June 2012 there were 5,700 inspections resulting in 1,400 infringement reports and two criminal charges. Overall, a new system has been introduced to improve the efficiency of civil enforcement of claims. However, weaknesses in the rule of law and corruption continue to have an adverse effect on the business environment and remain a major challenge.

Financial sector development

The repair of the balance sheets of banks continued during 2011 and 2012. Banks (of which 83% of capital is foreign-owned while 2.7% remains in state ownership) have sold part of their non-performing assets to their international parent banks or to factoring companies. Consequently, total bank assets contracted by the end of 2011 by 4.5% year-on-year, to some 86% of GDP, and further declined to 83% of GDP at the end of July 2012. The share of total gross loans has stabilised since October 2011 until July 2012 at around 57% of GDP, and most of this credit (94%) has been extended to the private sector. However, total bank lending still contracted by 11% year-on-year in 2011 and by 4% in the first seven months of 2012. Yet, a return of confidence is being recorded in the recovery of banks' deposits, growing by 1.5% year-on-year in 2011 and accelerating to 4% in July 2012. Moreover, foreign companies increased their saving in local banks (by 11% year-on-year in July 2012) for the first time since August 2009.

The interest rate spread of more than 6 percentage points (average lending interest rates were 9.73% in December 2011 compared to deposit rates of 3.08%) suggests there is room for increased efficiency in financial intermediation and the high risk aversion related to the still elevated ratio of non-performing loans (NPL). The NPL ratio fell to 15.5% of total loans at the end of 2011 compared to 21.5% a year before. In 2011, the liquidity of the banking sector remained above the minimum legal requirement of 10%. The capital adequacy ratio (CAR) further improved to 16.5% in 2011, up from 15.9% a year earlier. The profitability of the financial sector also improved compared to the previous year, although it still remained negative at the end of 2011. The sector recorded an aggregated loss of € 3 million in 2011, compared to € 82 million a year before. However, in the first half of 2012 credit activity still remained negative while NPLs were on the rise again, reaching 17% in June, and the CAR ratio declined to 14.5% due to negative financial results of some banks. Overall, weaknesses remain in the financial sector. Although deposits are gradually flowing back into the system, banks' capital and lending are declining.

In 2011, there were five leasing companies, the same as a year before, and they recorded an annual increase in the value of contracts of 11% in real terms, totalling 1% of GDP, a modest figure compared to the volume of bank loans. Most contracts related to passenger cars (86%) followed at distance by commercial vehicles (8%). In 2011, the Montenegro stock exchange index plunged by 35% and continued contracting during the first eight months of 2012 by 21% compared to the same period a year before. Furthermore, market capitalisation fell in August 2012 by 6.6%, although the total turnover surged by 122% year-on-year to € 5 million. Overall, the share of non-bank financial intermediaries remains low.

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

Existence of a functioning market economy

The financial sector has gained in stability, but is still unable and too risk averse to provide much needed credit to the economy. Unemployment remained high. Although market mechanisms are becoming more efficient, the aluminium plant indebtedness presents a potential risk for public finances.

Human and physical capital endowment

The recent educational reform focuses on the qualification system, which consists of several types of external examinations –on grounds of recommendations from industry and businesses– and aims to improve the quality of education and to align curricula with professional needs (see Chapter 26). The first Matura and vocational exams were organised for the 2011/2012 school year. Its results are now replacing entrance examinations to universities and other institutions of higher education at the end of high school. However, a high share of students from vocational and technical (VET) schools enrols in the university instead of entering the labour market, while employers report shortages for graduates with the right set of skills. Some 20% of persons with vocational education after primary school and 16% of persons with tertiary education remained unemployed in 2011. Overall, labour law reforms and measures to improve the quality of the education system have been initiated, but further efforts are required to re-align skills mismatches.

Investments in Montenegro rely heavily on foreign savings, with FDI inflows playing a key role in improving economic competitiveness, diversifying the industrial base and raising the productive capacity of the economy. Despite a sharp slowdown, annual net FDI inflows have remained above 10% of GDP, indicating sustained investor interest. However, investments have been largely focused on real estate, totalling 39% of total equity investments in Montenegro in 2011, while companies and banks received 33%, and a still significant 28% share concerned the settlement of inter-company debt. The liberalisation of telecommunications and energy has facilitated the opening of their respective markets (see Chapters 10, 14 and 15). However, important constraints are still present in energy, transport and environmental infrastructures. Overall, the country needs to attract further investments to develop its infrastructures.

In 2011 some 0.4% of GDP was invested in research and development, compared to 0.1% a year before. The Ministry of Science, with the support of the World Bank, commenced the project on higher education research for innovation and competitiveness. The Ministry also supported five initiatives by Montenegrin teams to participate in EU research projects. The ministry also co-financed scientific professional training abroad, doctoral and master studies and the publishing of scientific papers in reference scientific journals. Overall, Montenegrin institutions have started to participate more actively in European research programmes although private sector participation still remains insufficient.

Sector and enterprise structure

The steel company, one of the country's two large metal producers, was eventually sold in June 2012 after several unsuccessful tenders. However, the situation of the aluminium plant (KAP) remains uncertain as the company still needs to go through major restructuring. Meanwhile, further progress was recorded in network industries. The liberalisation of the electronic communications market has been completed. In November 2011 the Law on Postal Services was adopted and the national postal service was converted into a joint stock company, laying the basis for the complete opening of this market. The energy market was further liberalised. In March 2012 the government adopted the restructuring plan for Montenegro Airlines. The opening of the air transport market has been formally achieved. However, although the legislative work for the opening of the railways and the maritime transport markets was initiated, it has not yet been concluded (see Chapter 14- Transport policy). Overall, the restructuring of network industries is facilitating the opening of their respective markets.

There has been little change in the sectoral structure of the economy. The services sector remains the largest, accounting for some 70% of GDP. Agriculture represents about 9% of GDP, industry 14% and construction 7%. The informal sector remains large and is fuelled by weaknesses in tax and expenditure policies, as well as in law enforcement. SMEs account for some 66% of total employment. SMEs are still confronted with difficult access to credit. Some financial relief continued to be provided through the Investment and Development Fund (IDF) which increased the number of loans and established a factoring facility. However, the total amount of this support represented only 1.4% of total banks loans to private companies in 2011. The IDF project for development of business zones continues with the development phase in Podgorica and the selection of two new zones: in Berane and Kolasin. However, public sector financial cutbacks and organisational difficulties have led to a decline of support available to SMEs. The IDF established a credit guarantee scheme in April 2011, although no guarantees have been issued so far. Overall, the large informal sector and difficulties to obtain credit represent two major challenges for enterprise development.

State influence on competitiveness

Some progress has been recorded in the functioning and independence of regulators. In May 2012 the Agency for Electronic Communications and Postal Services instructed the incumbent operator to enable other companies to use the capacities of the cable infrastructure. Also in May, the Commission for the Control of Public Procurement annulled two important public tenders due to procedural irregularities, revealing increased independence despite the risk of interruption of the provision of medicines or internet services to the public administration. State aid was marginally reduced, from 2.3% of GDP in 2010 down to 2% in 2011. In May 2012 the Montenegrin Commission for State Aid Control ruled for the government to recover from the aluminium company € 30 million of state guarantees paid to a bank after the firm failed to service a loan. Overall, direct public support remains limited, but state guarantees are high and represent a risk for public finances.

Economic integration and convergence with the EU

Montenegro became a full member of the World Trade Organisation in April 2012. The total value of exports and imports of goods and services increased to 101% of GDP in 2011, compared to 94% a year before. However, the importance of the EU as the main trading partner has decreased somewhat, as the EU received 50% of total merchandise exports, compared to 56% a year earlier. The share of imports of goods from the EU fell moderately to 36%, from 38% a year before. The CEFTA market remains the second largest for Montenegro exports, receiving some 40% of its outbound trade in 2010 and 2011. The share of imports from CEFTA countries continued increasing, from 40% to 43%. Foreign direct investments decreased substantially in 2011. However, the share of EU investments expanded further, totalling 53% of total inflows into the country compared to 50% a year before. The Real Effective Exchange Rate (CPI-based) began to depreciate in 2011 (by 3.2%) after having stabilised the year before, thus marginally contributing to improved external competitiveness. Overall, while trade integration with the EU has somewhat slowed, the EU remains the main destination for Montenegro's exports and the main source for FDI.

4.3. CONCLUSIONS

After a moderate recovery in 2011, the economy of Montenegro decelerated in the first half of 2012. Domestic demand remains subdued due to weak credit growth and still large private sector debt overhang. In the absence of standard monetary policy tools the economic policy has continued to be oriented towards reinforcing economic and financial stability through the pursuit of fiscal consolidation and structural reforms. However, contingent liabilities from state guarantees have become a significant risk for the stability of public finances. Unemployment remains high while shortcomings concerning the rule of law, human resources and infrastructure persist.

As regards the economic criteria, Montenegro has made some further progress towards a functioning market economy. However, the unfinished restructuring of the metal industry, widespread liquidity problems and weak labour market conditions still impede an efficient allocation of resources. The country should be able to cope with competitive pressures and market forces within the Union over the medium term, provided that it continues to address current weaknesses through appropriate macroeconomic policies and structural reforms.

Macroeconomic stability has been broadly maintained. The banking sector is still recovering, with deposits gradually flowing back into the system. Further improvements have been made in market entry procedures and bankruptcy recovery. The efficiency of civil enforcement of claims has improved. Liberalisation of telecom and energy industries has facilitated the opening of their respective markets and their regulators have become more assertive. Participation in EU research programmes has been more active. Montenegro remains highly integrated in the EU and CEFTA markets.

However, large external imbalances persist. Labour market performance remains weak with very high unemployment rates. Inflationary pressures have been increasing. The deleveraging of the financial sector continues, causing liquidity problems and the subsequent accumulation of tax and other payment arrears in the economy. The stability of public finances has been furthermore challenged by pressures arising from contingent liabilities and unpaid contributions. The public debt continued to increase. The difficult economic situation of the aluminium producer needs to be addressed. While the country needs to attract further investments to develop its infrastructures, weaknesses in the rule of law and a large informal sector continue to hamper the business environment.

5. 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.

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

In January 2012, the government submitted to the European Commission its Economic and Fiscal Programme (EFP) for the period 2012-14. The programme's growth projections are optimistic, especially for 2012, and the plausibility of its targets is constrained by an outdated macroeconomic and fiscal scenario. The programme would have benefited from a more detailed description of policy measures to lead towards the declared objectives — sustainable growth based on exports and investment.

Serbia entered into a precautionary Stand-By Arrangement (SBA) with the International Monetary Fund (IMF) in September 2011. The completion of the first review has been postponed because the 2012 budget deviated from the agreed fiscal programme. After the elections at all levels in May, the new government is facing the challenge to urgently address the increasing fiscal imbalances and present and implement a comprehensive structural reform agenda. The independence of the central bank has been seriously challenged by the adoption of amendments to the Law on the National Bank of Serbia (NBS) in August.

Overall, economic reforms have mostly stalled in the election period. The consensus on the fundamentals of a market economy has been broadly preserved but needs to be reinvigorated in order to improve economic performance and enhance the resilience of the economy.

Macroeconomic stability

In 2011, Serbia's GDP increased by 1.6% in real terms. The pace of recovery slowed down significantly in the second half of the year and economic indicators point to a further deterioration of the economy, which contracted by an estimated 1.3% in the first and 0.6% in the second quarter of 2012. Growth in 2011 was rather narrow based as key sectors stagnated and even declined. This was particularly visible in manufacturing, real estate and agriculture, which grew by less than one per cent, and in wholesale and retail trade, which fell strongly by a real 5.5% compared to the previous year. Average per capita income in purchasing power standards rose to 35% of the EU average in 2011 from 34% in 2010. Overall, the economic recovery proved fragile and the economy has entered another phase of contraction.

Serbia's external position has been affected by the slowdown in the EU economy and in the region. After remaining stable at around 7% of GDP for about two years, the current account deficit increased to around 9% of GDP in 2011 and continued expanding to double-digit levels in the first half of 2012. A major drop in current transfers, mainly private remittances, was the main factor driving the deterioration in 2011, while trade and net factor income deficits remained broadly unchanged. After a peak in 2009-2010, remittances declined to about 7% of GDP, a level closer to their medium–term average. In 2011, both exports and imports of goods and services increased in euro terms by double digit rates. Still, the trade deficit remained relatively high at 17.2% of GDP and the surge in exports of the last two years has stalled. Export growth decelerated strongly in the last months of 2011 and even turned negative in early 2012, as foreign demand declined and particularly bad weather reduced general economic activity in the country, before rebounding slightly in the second quarter. Imports decelerated too but continued growing by close to 6% in euro terms in the first half of the year. As a result, the trade deficit expanded by 15% over that period.

Table 5.1:
Serbia - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	4,4	4,5	-3,5	1,0	1,6	-1,7
Private consumption	Ann. % ch	N.A.	N.A.	N.A.	N.A.	-0.5f	N.A.
Gross fixed capital formation	Ann. % ch	N.A.	N.A.	N.A.	N.A.	9.3f	N.A.
Unemployment (>15 years old)	%	18,1	13,6	16,1	19,2	23,1	25.5*
Employment (registered)	Ann. % ch	-1,1	-0,1	-6,1	-3,6	-3,1	-1,5
Wages (average, net real)	Ann. % ch	15,0	4,5	1,0	1,5	0,0	5,8
Current account balance	% of GDP	-16,1	-20,6	-7,3	-7,8	-9,6	-10.7*
Direct investment (FDI, net)	% of GDP	6,4	6,2	4,8	3,2	6,3	4,2
CPI (end of period)	Ann. % ch	11,0	8,6	6,6	10,3	7,0	4,4
Interest rate (3 months)	% p.a.	6,48	5,20	13,40	10,85	12,56	12,70
Stock markets	Index	4.096	2.604	1.197	1.283	1.270	972
Exchange rate RSD/EUR	Value	78,76	89,48	95,88	105,93	106,95	113,48
Nominal eff. exchange rate	Index	102,1	88,6	92,8	89,5	100,3	92,3
General government balance	% of GDP	-2,0	-2,6	-4,5	-4,7	-5,0	-6,1
General government debt	% of GDP	30,9	29,2	34,7	44,5	47,7	52,2

* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

The inflow of net foreign direct investments was significant in 2011 but turned negative in the first half of 2012. Portfolio and other investment inflows increased last year, on the back of significant government borrowing, while banks and other sectors reduced their liabilities. In September 2011, the government issued a USD 1 billion 10 year Eurobond. Short term commercial bank debt was reduced by two thirds, pushing the share of total short-term debt to below 3% of the external debt stock. This helped reduce Serbia's total external debt to below 80% of GDP in 2011. In the first half of 2012, banks continued to reduce their foreign liabilities. However, the external debt rose to 80% of GDP by end-July as its valuation increased following significant dinar depreciation in this period. In 2011, the central bank was able to increase significantly its reserves, but these gains were reversed in 2012 as FDI and portfolio investment inflows fell sharply and the bank intervened heavily to support the falling dinar. Nevertheless, by the end of August, foreign exchange reserves remained at a comfortable level, covering about seven months' worth of imports. Overall, the external adjustment remains unfinished, with significant and growing trade and current account deficits. External financing has weakened recently but short term risks are dampened by the still ample foreign exchange reserves and the favourable external debt structure, with a strong prevalence of long term debt.

In 2011 labour market indicators deteriorated for a third year in a row and worsened further in 2012. The unemployment rate climbed to 25.5% in April, from 23% in 2011 and 19.2% in 2010. Both activity and employment rates declined to their lowest levels in a decade. Most of the unemployment is structural as around three quarters of all unemployed have been without a job for more than a year. The economic growth of last year has not been conducive to employment creation and, according to the labour force survey, the number of employed people decreased by 6%. Employment declined even in sectors which had positive growth rates, implying gains in labour productivity and probably increasing informalities. Public administration, education and health care were a notable exception to this pattern and continued to expand. Employment continued to decline in the first half of 2012, with the number of registered employed falling by 1.5% compared to the same period in the previous year. Gross and net wages increased on average by a nominal 11% in 2011 and stagnated in real terms. Following the unfreezing of public sector salaries in early 2011, real wages have been growing by 2-

3% since mid-2011. Their increase accelerated by the end of 2011 and in the first half of 2012, mostly due to base effects and rapid deceleration in inflation. Following a 13% increase in April, the minimum wage has reached almost half of the average wage. Overall, labour market conditions deteriorated sharply and unemployment and sustainable employment creation represent a major challenge.

The monetary policy framework remained unchanged and the National Bank of Serbia maintained its commitment to price stability. The amendments to the Law on the National Bank adopted in August 2012 seriously challenged its independence, undermining the confidence in the monetary policy. The central bank lowered its end-of-the-year inflation target from 4.5% in 2011 to 4% in 2012, still within an unchanged tolerance band of ±1.5 percentage points. The target was missed by a wide margin throughout 2011, notwithstanding a gradual reduction of annual inflation to 7.0% by end-2011, compared to 10.2% a year before. Inflation was mainly driven by food prices, while energy and transport became the main sources of inflationary pressure in early 2012. As food prices moderated strongly and even declined for a few months in the spring of 2012, inflation continued to fall, reaching 2.7% in April, thus moving below the NBS target band. The central bank reduced its key interest rate, in several steps in line with falling inflation, from a peak of 12.5% in April 2011 to 9.5% in April 2012. Since then, on the back of renewed pressure from food prices, affected by a drought in the summer, inflation accelerated again, reaching 7.9% in August. The exchange rate of the dinar vis-à-vis the euro remained broadly stable in the second half of 2011. However, it has come under pressure since the beginning of 2012. Political uncertainties linked to the general elections and the formation of a new government, weaker net foreign currency inflows and deteriorating budget performance have led to a depreciation of the dinar, and by end September 2012 it had lost about 10% against the euro since the beginning of the year. In view of the high euroisation of the economy and significant pass through effects to inflation, the central bank intervened heavily on the market. It sold more than € 1.3 billion and increased the dinar share in the foreign exchange required reserves in an attempt to stem the fall of the dinar. Moreover, since June the bank increased, in three steps, its main policy interest rate to 10.5%. Overall, inflation has been volatile and general uncertainty, weaker net foreign currency inflows, and increasing budget deficits have weakened the dinar.

Fiscal performance has deteriorated. The overall budget deficit increased to 5.0% of GDP in 2011, up from 4.7% a year earlier, and compared to a deficit target of 4.6% of GDP in the revised budget adopted in October 2011. The higher than projected budget deficit resulted from lower economic growth and underperforming revenues, especially in the second half of the year. Almost all revenue categories, with the exception of excise duties (due to rises in effective rates) and corporate income tax, have decreased in real terms. Total revenue fell by 1.5 percentage points to 41.0% of GDP in 2011, while total expenditure decreased by 1.2 percentage points but remained high at 46.0% of GDP. Most of the expenditure categories have declined, with the biggest drops recorded in subsidies, social assistance and capital expenditure. However, spending on wages and pensions remained significant, pointing to a major imbalance in the structure of public expenditure. Following the rapid increase in government debt over the previous few years, interest payments to service the debt went up to 1.4% of GDP.

The original 2012 budget law targeted a reduction in the deficit to 4.25% of GDP. However, due to a strong acceleration in expenditure in the first half of the year, the deficit target had quickly become unattainable. In the first six months, total expenditure grew by a real 8.5%, driving the budget deficit to around 3.3% of GDP, more than 50% higher in comparison with the same period last year. There were strong real increases in capital expenditure, subsidies, purchases of goods and services and interest payments. In September, the newly-elected government announced a rebalancing of the 2012 budget, targeting an annual deficit of 6.7% of GDP. Most of the adjustment is expected to come from the revenue side, to be coupled with expected savings mainly due to lower indexations of wages and pensions. However, expenditure pressures related to additional spending on pensions, agricultural subsidies and support for some of the state-owned banks put at risk the achievement of the revised, and not very ambitious, 2012 deficit target.

Government debt continued to rise rapidly in 2012, driven both by the widening deficit and the depreciation of the dinar. It approached 55% of GDP by the end of July, far above the legally binding threshold of 45% of GDP, requiring the government to present a special programme to bring the debt back below 45% of GDP over the medium term. The deteriorating fiscal performance, among other factors, triggered a downgrade of Serbia’s long term sovereign credit rating in August. Overall, the budget deficit in 2011 remained high for a third year in a row and continued to increase at a rapid pace in 2012. Government debt went above the legally binding threshold already at the end of 2011 and continued to increase in 2012. The adoption and implementation of urgent and decisive consolidation measures, backed by systemic reforms of the public sector in order to restore public finance sustainability, remain a key challenge.

After several years of loose fiscal policy, fiscal space to cushion further shocks in the economy has been limited and fiscal sustainability is increasingly challenged. Delays in structural reforms are also weighing on the budget and the efficiency of policy responses. High budget deficits have constrained the effectiveness of the macroeconomic policy mix and the main burden of adjustment fell on monetary policy. Moreover, monetary policy continues to be restricted by the high degree of euroisation of the economy, which complicates the attainment of official objectives of inflation targeting and preserving financial stability. Overall, the policy mix is relatively imbalanced. Loose fiscal policy and a number of structural weaknesses overburden monetary policy.

Interplay of market forces

Price liberalisation has stalled and has even been partially reversed. The prices of about 22% of the goods and services in the consumer price index basket are administered and, for some of the goods, are kept below cost-recovery levels. The state has introduced indirect price control for certain groups of goods (basic foodstuffs). A government decree, in place until the end of 2012, caps retail trade margins for these products at 10%. The government has continued to control prices of public utilities directly, but also indirectly by setting a limit on increases in the prices of communal and public city transport services which are under the control of the local authorities. Overall, the state control over prices continues to be substantial and price liberalisation has stalled.

State influence in the economy remains high, due also to the predominant share of state ownership in major sectors of the Serbian economy such as energy (electricity and gas), railway and air transport and telecommunications. State owned companies, which are overstaffed in general, employ more than 10% of all employees in legal entities. They make a loss of around € 1 billion a year or about 40% of all losses in the economy. Privatisation of socially-owned companies has practically come to a halt. In 2011 only two enterprises were sold through a public tender (with sales receipts amounting to € 1.0 million and investment commitments of € 4.3 million) and two enterprises were sold through auctions. As a result of delayed privatisation, cancellation of contracts or re-nationalisation, the state still has control over a number of large companies in the manufacturing sector. Currently, the portfolio of the Privatisation Agency consists of 408 companies. There are 171 companies under a restructuring procedure and most of the remaining firms are to be sold through bankruptcy or liquidation.

In early 2012, the majority state owned Telecom Srbija bought back 20% of its shares from a foreign investor. With this buy back, the 1997 privatisation of 49% of Telecom Srbija has been completely reversed (29% had been bought back already in 2003). In April, the Serbian government decided to distribute 6.94% of the shares in Telecom Srbija to the company’s current and former employees, while another 15% was offered to all citizens. In another privatisation reversal, in February 2012, the Serbian government bought back from US Steel the ailing steel mill in Smederevo for a symbolic USD 1. Later, production at the mill, one of Serbia’s main exporters and employers, has been temporarily suspended. The steel mill has been running up large losses in the last few years and, until the government is able to re privatise the company, it will have to secure at least the maintenance costs, adding to government liabilities. Overall, in a difficult economic environment, the privatisation process has been very slow and even partially reversed. Sustaining competitive markets remains a key challenge.

Market entry and exit

Some steps have been taken to facilitate market entry. The ‘one-stop shop’ has further shortened the registration procedure, which now takes only two days on average (five days is still the legal maximum, with the principle of ‘silent consent’ in place). The registration fee stands at € 45 and the required capital for setting up a limited liability company has been reduced from € 500 to less than € 1. The setting up of new businesses is still seriously hampered by difficulties in obtaining construction permits and the process of dealing with construction permits and land remains costly and lengthy. Regulatory reform (the ‘regulatory guillotine’) is ongoing, although it has slowed lately. In an attempt to revive it, a new Strategy for regulatory reform 2011-2014 was adopted in late 2011.

The Law on Bankruptcy has introduced automatic bankruptcy for companies if their accounts are blocked for a certain period and, since the beginning of 2012, this period has been reduced from two to one year. Under the Law, the National Bank of Serbia is required to provide the commercial courts with information about these companies, so that bankruptcy proceedings can be launched. In the first half of 2012, it notified the courts about 11,231 companies with blocked accounts — about 50% more than in the same period the previous year. Overall, some steps have been made to simplify and speed up market entry, but red tape and difficulties in obtaining construction permits remain important obstacles. The bankruptcy procedure for companies that have been over-indebted has speeded up.

Legal system

The establishment of a real estate registry and a digital registration system has been completed. The new system will be able to provide quick and accurate information about real estate ownership, and this should facilitate contracts and investment decisions. Restitution legislation has been adopted but its enforcement remains to be tested. The Law on Planning and Construction and its amendments have led to differences in interpretation and thus in implementation at municipal level, which increases uncertainties for investors.

The uneven execution of laws, slow or non-existent enforcement, and proliferation of different administrative fees and charges increase the uncertainty and the cost of doing business. Moreover, the informal economy remains strong and is a major hindrance to fair competition and business development. Overall, legal predictability and enforcement of court decisions remain weak. Corruption and unclear property rights continue to hamper economic activities.

Financial sector development

The Serbian financial system is dominated by the banking sector, which had a 92% share of total assets in 2011. A total of 33 banks are operating in the country, unchanged from a year earlier. By the end of March 2012, foreign ownership had risen to about 74% of the banking sector and 21 banks operating in Serbia are owned by foreign entities. The five largest banks accounted for 47% of the total assets of the sector. There are nine state-owned banks, holding about a 19% market share, while the market share of domestic private banks is small at around 7%. Since the end of 2011, banking sector assets increased by 8.5%, accounting for approximately 94% of GDP by the end of July.

Capitalisation of the banking sector declined but still remains high. The average capital adequacy ratio stood at 17.3% in March 2012, well above the prescribed minimum of 12%. Deposits, of which over

75% are denominated in foreign currency, represent around 57% of the total liabilities of the banking sector. Similarly, loans account for some 60% of banking sector assets. About 70% of the loans are denominated in or linked to a foreign currency, predominantly the euro. More than half of all loans are granted to the corporate sector, while close to a third are extended to households. The quality of bank assets worsened, with the gross non-performing loans ratio reaching 20.4%, from 17.1% a year before. Banks profitability deteriorated in the course of 2011 and the return on equity decreased to just 0.2%. However, this negative development was mainly caused by the significant loss accumulated by Agrobanka. The bank has been put in receivership in the end of 2011, after the central bank established that the level of the bank's capital is not consistent with the degree of risk taken by the bank. The financial situation of Agrobanka did not improve and, in May, the Central Bank revoked its licence and granted an operating licence to the newly-established Nova Agrobanka, which took over all the liabilities and part of the receivables of the old bank. The new bank has been partially recapitalised by the Deposit insurance agency and the government. Following the failure of Agrobanka, in August the central bank took additional measures to increase its supervision of the banking system, focusing in particular on banks with significant share of custody accounts and state ownership. Overall, the banking sector remained well capitalised and liquid, but a weakening economy and depreciating dinar point to a growing risk of further deterioration in the quality of the loan portfolio. Bank supervision has been tightened, following the discovery of significant losses in one of the small banks.

The main index BelexLine of the Belgrade stock exchange fell by around 20% in 2011. This negative trend continued in the first nine months of 2012 and the index lost a further 10.6%. At the end of 2011, there were 28 insurance companies operating in Serbia, up from 26 a year earlier. Altogether 21 of them are in majority foreign ownership, while seven rely on predominantly domestic capital. The insurance sector's share in the total financial sector increased slightly, to 4.4% in 2011. The annual growth of premiums stood at a modest 1.4%, down from a 5.6% rise in 2010. The market was dominated by the non-life insurance segment, which accounted for 83% of the total. Overall, the role of the non-banking financial sector remained marginal.

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

Existence of a functioning market economy

Economic recovery has stalled and macroeconomic stability has weakened as domestic and external imbalances increased. Delayed reforms and the economic slowdown have exposed and aggravated structural weaknesses, such as low employment and volatility in prices and exchange rates. State presence and influence in the economy remains significant and has even increased. The private sector continued facing major obstacles. Key laws are in place, but the rule of law remains weak. Overall, the functioning of market mechanisms is hampered by distortions, excessive state involvement and legal uncertainty.

Human and physical capital

At present, there is still a large gap between demand for and supply of skilled workforce — with some professions oversupplied and others lacking. Enrolment in education in both primary and secondary schools is high and is increasing over time. The number of people with higher education is low (currently 6.5 % of the population) but is envisaged to increase sharply in the course of this decade according to the draft education strategy for the period until 2020. Important elements of the strategy are the introduction of mandatory secondary education and the plans to reform vocational training, bringing it closer to the needs of the labour market. To back the achievement of its goals, the strategy envisages an increase in public spending on education to 6% of GDP in 2020, up from 4.2% in 2011.

Overall, further steps remain to be taken to implement a strategy of reforming the education and training system in order to improve its performance and respond better to labour market needs.

Serbia continues to need significant investments to improve and upgrade its physical infrastructure. Government investments have been constrained by a difficult budgetary situation and declined to 3.5% of GDP. Nevertheless, works on major transport corridors (such as pan-European Corridor X) progressed, albeit slowly, but investments outside the main corridors are lagging behind. Energy efficiency continues to be low and energy infrastructure, in particular electricity generation and distribution, needs further investments. Net FDI more than doubled in 2011, reaching 5.8% of GDP. A large share of the inflows related to a single non greenfield investment in the retail sector and part of the remaining inflow has benefited from budget subsidies. Besides trade, the other two sectors which attracted most of the FDI were manufacturing and financial and insurance activities. Overall, the physical infrastructure needs large investments. Government investments have been constrained by an increasing budget deficit and FDI has been channelled mostly to non-tradable sectors.

Sectoral and enterprise structure

The shares of agriculture and industry edged up slightly in 2011, reaching 10.4% and 27.7% of total value added respectively, while the share of services fell from 63.0% to 61.9%. Employment declined across the three sectors but the fall was more marked in agriculture — its share in total employment dropped from 21.5% in April 2011 to 20.4% in April 2012. The share of industry remained broadly unchanged and employment in services increased to 53.4% of the total. Weak tax and expenditure policies and poor law enforcement, including in the fight against corruption, continue fuelling a sizeable informal sector. Overall, the economy continued to be dominated by services and the share of agriculture remained significant. The informal sector is a significant challenge.

State influence on competitiveness

State subsidies reported in 2011 were 6% higher than in 2010, representing 2.6% of GDP. Of the total State aid granted in 2011, only 16.3% was in the form of horizontal aid, 41.1% was for regional aid, 22.1% was sectoral aid, and 20.5% went for agriculture. There was barely any aid to training and to research and development. Most of the aid was given in subsidies (close to 60%) and as tax incentives (31% of total). The state-controlled monopolistic structures remain in a number of sectors (e.g. energy, transport, infrastructure, postal services, telecommunications, broadcasting, agriculture and the environment) and the state continued to subsidise heavily the transport sector, which received almost a fifth of all aid. Overall, the state continues to substantially influence competitiveness by providing significant and wide ranging forms of State aid.

Economic integration with the EU

The EU remains Serbia’s main trading partner, accounting for 57.7% of the country’s total exports and 55.6% of its total imports in 2011. While the share of exports to the EU has increased somewhat, the share of imports has decreased slightly. The CEFTA countries accounted for 14% of Serbia’s trade in 2011, having declined from 14.8% in 2010. The share of net FDI inflows from the EU in total net FDI inflows reached 88% in 2011. Real gross wage growth, at 0.3% in 2011, was considerably smaller than average labour productivity growth, which translated into a fall in real unit labour costs. In real effective terms (deflated by inflation), the dinar appreciated by 4.4% in 2011. However, by end of July 2012, the real effective exchange rate of the dinar weakened by 8%. Overall, trade integration with the EU remained high.

5.3. CONCLUSIONS

The economy of Serbia continued to grow in 2011 by 1.6% but recovery weakened significantly in the second half of the year before turning into contraction in the first half of 2012. Unemployment soared at 25%. The budget deficit reached 5% in 2011 and was even higher in the first semester of 2012. Serbia entered into a precautionary Stand-By Arrangement with the International Monetary Fund in September 2011 but the completion of the first review has been postponed because the 2012 budget deviated from the agreed fiscal programme. Economic reforms have mostly stalled in the pre-election period. The independence of the central bank has been seriously challenged by the adoption of amendments to the Law on the National Bank of Serbia in August. The IMF conducted a fact-finding mission in September 2012 but talks have not restarted yet on a stand-by agreement.

As regards the economic criteria, there was no further progress in the reporting period towards establishing a functioning market economy. Serbia needs to make significant efforts in restructuring its economy so as to cope in the medium-term with the competitive pressures and market forces within the Union.

The consensus on the market economy fundamentals has been broadly preserved but needs to be reinvigorated. Short term external financing risks are dampened by the still ample foreign exchange reserves and the favourable external debt structure, with a strong prevalence of long term debt. Trade integration with the EU remained high. The banking sector is well capitalised and liquid. The central bank stepped up its supervision of the banking sector. Some steps have been taken in speeding up and facilitating market entry. Some limited steps have also been taken in order to improve the business environment notably in the areas of company law and SME policy.

However, high budget deficits have constrained the effectiveness of the macroeconomic policy mix and the main burden of adjustment fell on the monetary policy which continues to be restricted by the high degree of euroisation of the economy. Labour market conditions deteriorated sharply with rising unemployment. Sustainable employment creation represents a major challenge. Lax fiscal policy and increasing government debt are rapidly limiting fiscal space to cushion further shocks. There is a need of urgent and decisive consolidation measures, backed by systemic reforms of the public sector, in order to restore public finance sustainability. Delays in structural reforms are also constraining the scope for growth enhancing policy responses. Special attention is needed to further improve the business environment. The development of a dynamic private sector has not made progress and state interference in the economy remains very high. Privatisation and restructuring of publicly-owned companies advanced very slowly and, in some cases, earlier privatisations have even been reversed. Legal predictability remains weak and unclear property rights continue to hamper economic activities. The informal sector remains an important challenge.

6. TURKEY

In examining 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.

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The Pre-Accession Economic Programme (PEP) submitted to the Commission in January 2012 reflects commitments to a rebalancing process away from debt fuelling consumption towards exports. Although such adjustment process is positive for economic stability, Turkey has large external imbalances, and remains vulnerable to further global financial shocks, in particular capital flow reversals. As more ministries and governing structures have been created, the fragmentation of responsibilities between government bodies appears to be increasingly complicating coordination for budgeting and medium-term economic policy making. Decisions are sometimes taken on an ad hoc basis and impact assessments are either lacking or based on partial information. However, there have been no major instances of internal conflicts and tensions in economic policies in recent times. Overall, the consensus on economic policy essentials has been preserved.

Macroeconomic stability

In 2011, the Turkish economy grew by 8.5%, only slightly down from 9.2% in 2010. Growth was largely driven by the private sector, with consumer spending up 7.7% on the year and private sector investment up 22.8%. The strength of domestic demand led to import volumes increasing 10.6% on the year, while the level of export volumes was 6.5% higher than in 2010, partly as a result of the depreciation of the Turkish lira (by 20% vis-à-vis the euro in 2011). Since mid-2011, however, the pace of growth has been slowing down gradually in line with the slowdown in domestic demand, accompanied by an improvement in the trade and current account balances. A major growth deceleration was observed in the first half of 2012, to 3.1% year-on-year. Private domestic consumption (residents households), which accounts for over 70% of GDP, was down by 0.2% year-on-year in the first six months of 2012, while fixed investment decreased by 3.2%, compared with a 18.3% increase in 2011. The only domestic demand component that posted above-average growth was government consumption, which increased by 4.9%. A further deceleration is already being witnessed to some extent in leading indicator data. Surveys of manufacturing business confidence and capacity utilisation have recently fallen back to their weakest levels in two years. However, industrial production and credit growth accelerated in mid-2012 after a couple of weak quarters. In 2011, the per capita GDP of Turkey (PPP adjusted) amounted to 52% of the EU average. Overall, economic growth is slowing down, from high levels, due to weaker domestic demand.

The current account deficit rose from 6.6% of GDP in 2010 to 10% in 2011. The increase was entirely due to the deterioration of the merchandise trade deficit. In 2012, Turkey continued to run a large current account deficit, which leaves the Turkish currency vulnerable to a sudden loss of investor confidence. However, the deficit has been narrowing, to about 8.5% of GDP by mid-2012, mainly as a result of an improvement in the merchandise trade deficit owing to weaker domestic demand, lower oil prices and strong export growth. Given the slowing of the economy and falling energy and food prices, the current account deficit is expected to fall further in the months ahead, although an expected deterioration in external economic conditions may make the increase in export earnings difficult to sustain. Capital inflows (including net foreign direct investment, foreign purchases of government bonds in the international and local markets and foreign lending to Turkish banks and companies) largely offset the current account deficit during 2011 and the first half year of 2012, although they were significantly lower than a year earlier. In 2011, a large positive balance was recorded for the net errors and omissions item of the balance of payments, which is thought to reflect informal repatriation of funds held abroad. At the same time, foreign direct investment remains low proportionally to the size of the current account deficit, at only 13% of total capital inflows over the first six months of 2012. Turkey's large dependence on shorter-term capital makes it highly susceptible to the current global uncertainties. The Central Bank's official reserves decreased from € 61 billion in 2010 to € 56 billion in 2011, but these losses have already been mitigated by mid-2012. At the same time, gross external debt decreased from 39.9% of GDP to 39.7% of GDP. In early May 2012, the parliament passed a bill easing restrictions on property purchases by foreigners, which is likely to increase capital inflows for this purpose. Overall, the external imbalances have remained significant.

Table 6.1:
Turkey - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	4,7	0,7	-4,8	9,2	8,5	3,1
Private consumption	Ann. % ch	5,5	-0,3	-2,3	6,7	7,8	-0,2
Gross fixed capital formation	Ann. % ch	3,1	-6,2	-19,0	30,5	18,5	-3,0
Unemployment	%	9,9	11,0	14,1	12,0	9,8	9,3
Employment	Ann. % ch	-3,6	1,3	0,4	6,2	6,7	2,9
Wages	Ann. % ch	9,5	11,6	9,9	11,8	10,1	12.2*
Current account balance	% of GDP	-5,9	-5,5	-2,2	-6,4	-10,0	-8,8
Direct investment (FDI, net)	% of GDP	3,1	2,3	1,1	1,0	1,7	1,7
CPI	Ann. % ch	8,8	10,4	6,3	8,6	6,5	10,0
Interest rate (3 months)	% p.a.	18,85	18,04	10,68	7,95	9,09	11,76
Stock markets	Index	48.270	37.582	37.510	59.484	60.751	58.563
Exchange rate TRY/EUR	Value	1,78	1,91	2,16	2,00	2,33	2,34
Nominal eff. exchange rate	Index	26,7	25,8	23,2	24,3	20,9	N.A.
General government balance	% of GDP	-1,0	-2,2	-5,7	-3,6	-1.4f	N.A.
General government debt	% of GDP	39,4	39,5	45,5	41,6	38.4f	N.A.

* Industrial Sector Q1

Sources: Thomson Reuters/Ecowin, Eurostat

Unemployment was 9.8% in 2011, down from 11.9% in 2010. In the half year of 2012, unemployment fell further to 8.9%. The employment rate stood at 45.3% in the first semester of 2012, up from the 44.9% observed in December 2011 and 43% in 2010, while non-farm unemployment fell to 10.1% in May 2012 from 11.6% the year before. While the labour participation rate is 71.4% for men, it is as low as 30% for women, in spite of an increase of more than 4 percentage points from a year earlier. Despite the low proportion of the female population actively looking for work, the female unemployment rate is slightly higher than the male unemployment rate. In addition, about one third of women who are considered as employed are unpaid family workers in the agricultural sector. This reduces the percentage of women of working age who are employed and receive an income to less than 15% of the total. Lack of affordable child care is among key barriers for women's entry into the labour market. The labour market needs to absorb the unemployed and about one million new entrants every year. Overly strict employment protection laws discourage employers from hiring. The prevalence of undeclared work remains a major challenge. Overall, robust economic development allowed strong employment growth and a drop in unemployment.

Inflation was 10.5% in 2011, almost doubling from 6.4% in 2010 and the official target of 5.5%. Annual core inflation amounted to 9.8% in 2011. By August 2012, however, consumer prices have dropped, in spite of highly volatile energy and food prices, to 8.9% year-on-year. Core inflation amounted to 7.8% in August. Partly in view of the recent increase in food prices, the Central Bank's year-end inflation target of 5%, with a 2 percentage points tolerance band, appears to be within reach, helped by favourable base effects. By end-September 2012, market expectations amounted to 6.8%. Overall, inflation has been high, but came down in mid-2012 in spite of rapidly rising food prices.

Concerns about the level of inflation and the vulnerability of the lira to heightened global risk aversion, owing to Turkey's still large current account deficit, have continued to pose obstacles to a significant easing of monetary policy. Since late 2011, the Central Bank has operated rather complex policies, based on an interest rate corridor and various targeted macro-prudential measures, which have allowed it to adjust banks' funding costs on a day-to-day basis. The Central Bank has been compelled to sustain a tightening bias over the past half year, in spite of some softening in recent months. Since July 2012, the average bank funding rate fell from about 10% to below 7%, still more than two percentage points higher than the one week repo rate of 5.75%. Given the inflation volatility and the current weakness of the lira (alongside most emerging market currencies) on the back of renewed financial stresses in the eurozone, tight monetary policy needs to persist in order to safeguard Turkish financial stability. The tightening appears to be increasingly successful in shifting the drivers of growth away from domestic demand. However, more support from the fiscal side, besides the specific and targeted macro-prudential measures that are put in place, including by the banking regulator, may help engineer a rebalancing and soft landing of the economy and ease the burden placed on monetary policy. Overall, monetary policy has been increasingly successful, as it was able to curb the growth of credit and contribute to easing the current account deficit at the same time.

The budget performed better than expected in 2011, especially due to the robust recovery in domestic demand, which provided significant support to indirect tax revenues. The primary surplus rose from 0.5% of GDP in 2010 to 1.3% of GDP in 2011, and the overall central government budget deficit fell from 3.6% of GDP in 2010 to 1.2% of GDP in 2011, compared with a budget target of 1% of GDP. The social security deficit decreased from 2.4% of GDP in 2010 to 1.3% of GDP in 2011. The recent public receivables restructuring programme had a positive impact on the social security system balances, generating extra revenues of € 3.3 billion, or 0.6% of GDP. In the first half of 2012, weaker demand adversely affected the budget performance, and real tax revenues were roughly at the same level as in 2011, as indirect taxes — which make up two thirds of the total — were curtailed by the slowdown in consumer and import demand. According to the medium-term fiscal plan, the government expects a budget deficit of 1% of GDP in 2012. This target has not been adjusted for economic growth and revenues that were higher than anticipated in 2011. Therefore, fiscal policy may have more scope to support the monetary policy efforts aimed at curbing domestic demand and thus the current account deficit. The public debt stock fell further in 2011, and it amounted to 39.4% of GDP by the end of 2011. Overall, fiscal performance was satisfactory.

Four years after the adoption of the Public Financial Management Law, some components are still missing, in particular measures to enhance the accountability, efficiency and transparency of the budgeting process. Consolidated general government accounts according to international accounting standards are still not regularly published. This makes it difficult for citizens to hold the government accountable for its management of public money. Full implementation of the new Law on State Aid has been postponed. The unification of all tax administration functions under the Revenue Administration has been announced. The aim of this unification was to strengthen the audit capacity and facilitate greater use of standard risk-based audit techniques, thereby enhancing transparency. Overall, no efforts were made to increase fiscal transparency.

Turkey's fiscal and monetary policy mix proved relatively successful in the aftermath of the crisis. The earlier fiscal consolidation and structural reforms have contributed to robust growth. However, making more progress with fiscal transparency, adjusting the fiscal policy stance, doing more to target inflation and preserving financial stability will be important ways to engineer a soft landing of the economy and ensure sustainable growth. In particular, a sudden reduction or reversal of capital flows could put pressure on the lira, resulting in higher inflation. The adoption of a strong fiscal rule may not only enhance fiscal transparency, but also provide a strong fiscal anchor and enhance credibility.

Overall, the soft landing of the Turkish economy remains vulnerable to bouts of financial uncertainty and the global risk sentiment and more could be done to better coordinate and optimise the policy mix.

Interplay of market forces

The share of administered prices in the Consumer Price Index (CPI) basket remained at only 4.5%. At the same time, food and alcohol prices – more than 25% of the consumer basket are highly sensible to policy and administrative decisions. Regulatory and surveillance agencies are in place in all major sectors. Automatic pricing mechanisms are operational in the natural gas and electricity sectors, where end-user prices are officially linked to a cost-based methodology. However, the government increasingly interferes and independently sets prices, thereby suspending automatic mechanisms including in the transport sector.

There has been limited progress in the restructuring and transparency of state-owned enterprises. The pace of privatisation slowed down significantly, chiefly due to investors' difficulties in gaining access to long-term external financing. As a result, tenders for two electricity distribution companies remained inconclusive. Deadlines and procedures for various tenders, including the natural gas tender, were extended. Total privatisation receipts decreased from € 2.2 billion in 2010 (0.4% of GDP) to € 971 million (0.2% of GDP) in 2011. Major deals completed in 2011 were the port of İskenderun (€ 266 million) and the Trakya electricity distribution company (€ 411 million). Planned privatisations for 2012 include major electricity generation assets, highways and bridges, and several ports. Remaining shares in Turkish Airlines, Turk Telekom, Petkim, and state-owned banks Halkbank and Vakıfbank may also be the subject of new privatisation deals. There is no plan for the privatisation of Ziraatbank and the national lottery yet. Overall, the government has been increasingly interfering in the price-setting mechanism and difficulties in gaining access to external financing have slowed down privatisation.

Market entry and exit

In 2011, the implementation of the business registration process was fine-tuned. However, starting a business in Turkey remains costly and corresponds to 11.2% of per capita income. Some fees are still not transparent, such as those for the official registration of a company's articles and accounts. Trade registry fees are significant. Progress in removing exit barriers remains weak. Closing a business is still expensive and time-consuming. Insolvency procedures take about 3.3 years and recovery rates — at 22% on average — remain very low. Registering a property in Turkey costs 3.3% of its value, requires six separate procedures and takes six days. Obtaining a construction permit is expensive and time-consuming: on average, it takes 24 procedures and 189 days. Costs correspond to almost 200% of the average per capita income. Overall, market entry is satisfactory, while market exit remains costly and long, and insolvency proceedings are still heavy and inefficient.

Legal system

A reasonably well functioning legal system, including in the area of property rights, has been in place for several years. Enforcement of commercial contracts is still a rather lengthy process, involving 36 procedures and taking an average of 420 days. Commercial court judges lack specialisation, which results in lengthy court proceedings. The expert witness system still operates as a parallel judicial system, but does not improve the overall quality. Out-of-court dispute settlement mechanisms are seldom used. The judicial system and administrative capacity can be further improved. Overall, the legal system continues to function relatively well, but no progress has been observed.

Financial sector development

In 2011, the financial sector continued to perform well, and total financial sector assets increased by almost a third. Risk ratios in the financial sector remained robust. Banks continued to dominate the sector, as their share of total financial sector assets remained about 80%. Banking assets values are about 100% of GDP. The share of state-owned banks in total banking sector assets decreased from 30% in 2010 to 26% in 2011, while domestic private banks had a 32% share. Foreign banks' share reached 21.9% (41.6%, if ownership through the stock exchange is also included). There was no progress in the privatisation of state-owned banks planned a long time ago. The share of the insurance sector remained small and underdeveloped, with 3% of the total financial sector. Largely in tandem with the growth performance, credit expansion slowed down gradually, from about 40% year-on-year in mid-2010, to about 12% by mid-2012. Both the banking sector loan stock and its deposits' stock amounted to about 50% of GDP by mid-2012. The loans to deposits' ratio increased gradually from 83% in 2010 to 99% in the second quarter of 2012. The value of outstanding debt instruments traded in the bond market amounted to about 40% of GDP. Private debt issues increased significantly, from 1.3% of the total equity market in 2011 to 4.1% in mid-2012. The share of non-performing loans in total banking sector loans decreased from 3.7 in 2010 to 2.7% by the end of 2011. The capital adequacy ratio decreased further, from 19% in December 2010 to 16.5% in June 2012, still significantly above the statutory minimum of 12%. The authorities established a financial stability committee under the chairmanship of the deputy prime minister in charge of the economy. The committee aims to monitor systemic risks and their management and identifies policy measures to be undertaken. The committee met eight times since its establishment in June 2011. Overall, the financial sector has continued to show dynamism and strength thanks to earlier in-depth reforms.

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

Existence of a functioning market economy

Turkey's robust growth in a context of major global volatility confirms the economy's improved fundamentals and enhanced resilience to shocks. However, the rapid expansion of the current account deficit and strong inflationary pressures point to the return of significant imbalances in the Turkish economy. Overall, the functioning of market mechanisms has remained intact.

Human and physical capital

The educational reform programme, which is a key component of the National Development Plan 2007-2013, is coming to an end. It sets two key priorities for education modernisation and reform: namely increasing the responsiveness of education to demand and enhancing the quality of the education system. By 2011, some progress has been made. Illiteracy rates for the population aged 15 or above decreased from 7% in 2010 to 5.7% in 2011 and from 11.4% to 9.4% for women. The ratio of university graduates in the population aged 15 or above increased from 9.2% in 2010 to 10.8% in 2011. The net schooling ratio in primary education (eight-year cycle) increased slightly, while the net schooling ratio in secondary education also increased significantly, from 65% to 69% during the same period. However, challenges have remained substantial. Participation in higher education remains low by international standards and, although there has been some progress and the top students in Turkey are performing well, the vast majority of Turkish students display low proficiency levels in basic skills and problem-solving. As from the school year 2012-2013, compulsory education has been extended from 8 to 12 years. This decision has been taken without proper impact-assessment. It may imply a significant fiscal cost and affect the overall education quality. Turkey increased funds for active labour market policy significantly. Overall, reforms and increased spending on education have so far generated a positive impact on educational attainment and schooling rates, but significant problems remain with regard to the quality of education.

Investment rose from 18.9% of GDP in 2010 to 21.9% in 2011, entirely thanks to private sector investments, which increased from 15% of GDP to 18.1% of GDP. Gross FDI inflows to Turkey increased from € 6.8 billion to € 9 billion. Although the official aim of the government is to increase expenditures on research and development to meet the target of 2% of GDP, the actual outcomes remain much lower, given that R&D expenditure amounted to just 0.84% of GDP in 2010 (latest available data). Growth in gross electricity consumption has averaged around 6% in each of the past five years, and no extra power generating capacity has been built. Modest progress was made in the upgrading of infrastructure. Overall, improvements in the country's physical capital have been modest.

Sectoral and enterprise structure

The share in employment of agriculture and construction stabilised at 25.5% and 7% respectively in 2011. Fewer jobs were created in services and industry, whose share in total employment went down to 48% and 19.5% respectively in 2011. Growth has been particularly job-rich as overall employment grew by 6.7% in 2011, slightly up from 6.2% in 2010. At the same time, the relative output of the service sector fell by one percentage point to about 63%, while the share of agriculture and industry went up marginally to 8% and 26% of GDP respectively in 2011.

Progress in liberalising the utilities sectors has been uneven. The draft Electricity Market Law, which is to repeal the existing one, was discussed with stakeholders and sent for the approval of the Prime Ministry. However, no tangible progress can be reported on reducing BOTAS' (gas) monopolistic market share while attempts to replace the terminated contract with the Russian Federation by contracts with the private sector remained unsuccessful. Regarding the telecommunications market, steps to increase the level of competition in the market continued. The wholesale line rental (WLR) implementations which started in February 2012 further enhanced competition, in particular in the broadband and fixed telephony markets. Overall, the liberalisation of network industries gathered pace.

State influence on competitiveness

Only very limited progress was made in the area of State aid. The legislation implementing the State Aid Law was originally scheduled to be enacted by the end of September 2011. However, a decree-law issued in November 2011 stipulated that this legislation would only enter into force by the end of June 2013. The implementing legislation concerning the State Aid Authority is not in place yet. However, a significant incentives package, superseding the 2009 stimulus package, was presented by the Turkish authorities in early April 2012 and adopted in June 2012. The State Aid Authority is still expected to formally establish a comprehensive State aid inventory and an action plan for aligning all State aid schemes with the acquis. The legal framework for public procurement continued to comprise various exemptions and is still not in line with the EU acquis. Overall, there has been very limited progress in enhancing the transparency of State aid.

Economic integration with the EU

The openness of the economy as measured by the value of exports and imports of goods and services as a percentage of GDP increased significantly from 48% in 2010 to 56.5% in 2011. At the same time, the EU's share of Turkey's total trade decreased from 41.7% in 2010 to 40.8% in 2011. Between 2010 and 2011, the EU share of Turkey's exports remained stable at 46%, while its import share decreased from 42.6% to 41.7%. However, first half of 2012 data indicate that shares have been falling due to a weakening of EU demand. The EU continued to be the main source of FDI inflows to Turkey, albeit with a falling share: 76% in 2010, and 71% in 2011, as FDI from non-EU countries increased more than from the EU. In nominal terms, foreign capital investment inflows originating from the EU countries — excluding real estate — more than doubled in one year, increasing from € 3.5 billion to € 8 billion. Overall, trade and economic integration with the EU remained high.

Based on the information available on real wage developments, unit labour costs appear to have increased at a slightly faster pace than labour productivity in 2011 and the first half year of 2012. Labour costs went up in 2011 by 10.2% for the whole economy, by 9.1% in manufacturing, and by 14.1% in the construction sector. Conversely, the non-wage labour cost index, which shows social security contributions and severance payments per hour, increased by 9.1%. The Turkish lira depreciated vis-à-vis the euro by 20% and against the US dollar by 23.3% in 2011. The real effective exchange rate (against a basket of 50% US dollar and 50% euro) also decreased in 2011 by about 15% (the CPI-based REER index decreased from 125.7 in 2010 to 109.5 in 2011). High inflation and some appreciation in 2012 caused the REER index to climb to 115 in mid-2012. Overall, Turkey's international competitiveness has increased, primarily due to a depreciation of the currency in 2011.

6.3. CONCLUSIONS

The economy of Turkey continued growing strongly, thus reaping the rewards of the stability and growth oriented policies implemented in most of the previous decade. Since mid-2011, the pace of growth has been falling gradually in line with the slowdown in domestic demand, accompanied by an improvement in the trade and current account balances. However, the still sizeable external imbalances and significant inflationary pressures continue to pose a threat to macroeconomic stability.

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

In 2011, the Turkish economy grew by 8.5%, only slightly down from 9.2% in 2010. Growth was largely driven by domestic demand, in particular stemming from the private sector. A major growth deceleration was observed in the first half of 2012, to 3.1% year-on-year. The slowdown in domestic demand is accompanied by an improvement in the trade and current account deficits, albeit from very high levels (10% of GDP in 2011). The robust economic expansion also allowed strong employment growth and a drop in unemployment from about 11% in mid-2011 to less than 9% a year later. Monetary policy has become more instrumental and has been successful in curbing the growth of credit, and reducing the current account deficit. The budget performed better than expected in 2011, and public debt fell to about 39% of GDP by mid-2012. Reforms and increased spending on education have generated some positive impact on educational attainment and schooling rates. Trade and economic integration with the EU remained high.

At the same time, the soft landing scenario is challenged by bouts of financial uncertainty and the global risk sentiment and more may need to be done to better coordinate the policy mix. The current account deficit is still sizeable. Inflation has been falling, but remains high. These imbalances signal competitiveness problems and a lack of domestic savings, and call for further structural reforms. No efforts were made to increase fiscal transparency and better anchor fiscal policy, which would also contribute to enhance Turkey's credibility in the markets. Market exit remains costly and long and bankruptcy proceedings are still relatively cumbersome. To improve business competitiveness, the law on State Aid should be fully implemented. While there were some improvements in the country's human capital, improvements on physical capital have been modest.

7. 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.

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

Despite a generally polarised political landscape, the main parties agree on the key essentials of a market economy. Nevertheless, the political situation renders the adoption and implementation of structural reforms more challenging. The government's main economic policy objective is still to preserve macroeconomic stability, which was broadly maintained. However, the increase in the fiscal deficit in 2011 led to a further rise in the relatively high public debt, aggravating Albania's macro-financial vulnerability. Progress on structural reform remains insufficient. In particular, the privatisation programme has practically stalled and the institutional set-up to protect property rights and enforce the rule of law is weak. Albania submitted its sixth Economic and Fiscal Programme, covering the period 2012-2014, in February 2012. The programme presents an optimistic medium-term macroeconomic scenario. The treatment of risks to the budgetary outlook and the structural obstacles is still insufficient. Overall, the consensus on the main fundamentals of a market-oriented economy was maintained.

Macroeconomic stability

According to provisional data, economic growth decelerated to 3.1% in 2011 from 3.8% a year earlier. Domestic demand was the main driver of GDP growth, spurred by gross fixed capital formation, which rose by 3.6%. Private consumption growth slowed down to 2.6%, suppressed by weak lending to households and a further decline in workers' remittances. The contribution made by net exports to GDP growth was negligible. The Albanian economy contracted by 0.2% year on year in the first quarter of 2012, driven by strong declines in industry and construction output, partly due to adverse weather conditions. As a result, electricity output declined leading to disruptions in the extractive sector. Agriculture and other services output increased. Consumption expenditure and investment remain weak partly reflecting the uncertain global economic situation. Per capita GDP in terms of purchasing power parity was estimated at 31% of the EU 27 average in 2011, up from 28% in 2010. Overall, the Albanian economy continued to grow in 2011, driven by domestic demand, but economic activity practically stagnated in the first quarter of 2012.

The annual inflation rate averaged 3.5% in 2011 and remained within the Bank of Albania's (BoA) target range of 2-4%. The main contributors to inflation were international food and fuel prices. Lower prices for imported food and the unwinding of base effects led to a deceleration of inflation in 2012, which reached a low of 0.6% in February. Inflation accelerated in the subsequent months, reaching 2.8% in August. The supervisory council of the BoA cut the key repo rate in five equal steps, starting from September 2011, by a total of 125 basis points to a multi-year low of 4%.

Notwithstanding several measures adopted by the monetary authorities, the level of euroisation in Albania remains high. Foreign-denominated loans stood at 68% of the total credit outstanding in 2011, of which more than half consist of un-hedged loans, while foreign currency-denominated deposits account for 50%. Such high euroisation constrains the room for manoeuvre of monetary policy and could be a potential source of instability in the financial system, since it could expose banks to currency mismatches or indirect credit risks.

Albania continued to pursue a free-floating foreign exchange rate system. The lek was more stable in 2011, compared with the previous year, depreciating by some 2% against the euro. During the first eight months of 2012, the Albanian currency appreciated marginally reaching 1.8% year on year in August. Overall, monetary policy remained sound, inflation kept within the target range and exchange rate stability was broadly preserved.

Labour market conditions improved somewhat during 2011, but unemployment remained high at 13.3%, down slightly from 13.7% in 2010. Employment grew on the back of private non-agriculture job creation. In the first half of 2012, employment continued growing although at a decelerating rate of some 1%. Unemployment remains persistently high, while long-term unemployment accounts for around three quarters of total jobseekers, reflecting its structural nature. Labour market statistics continue to be weak and are distorted by the large informal sector. Overall, labour market outcomes slightly improved. Although lower, unemployment remains persistently high.

The current account deficit widened to 12.2% of GDP in 2011, from 11.3% a year earlier, primarily reflecting a higher trade gap and a lower services account surplus. The large trade deficit increased to 23.8% of GDP in 2011, from 23% in 2010, due to a slowdown in exports and an increase in imports. Unfavourable weather conditions in the second half of 2011 dented Albania's hydropower generation which resulted in a switch from exporting to importing electricity and disruptions in the extraction industries that lasted until the first quarter of 2012. The current account imbalance improved in the first half of 2012 as electricity output recovered in April and exports of goods turned positive which, together with a drop in imports, led to a lower trade gap. In addition, the services account posted a surplus in the first half of 2012 helped mainly by strong inbound tourism which more than offset a decline in remittances.

Table 7.1:
Albania - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	5,9	7,5	3,3	3,8	3.1e	-0.2*
Private consumption	Ann. % ch	13,4	9,8	7,7	2,2	2.6e	N.A.
Gross fixed capital formation	Ann. % ch	6,5	12,9	2,4	-5,2	3.6e	N.A.
Unemployment	%	13,4	12,8	13,0	13,7	13,3	13,3
Employment	Ann. % ch	0,2	2,9	-0,8	-4,7	2,0	0,9
Wages, public sector	Ann. % ch	17,1	8,3	11,9	6,7	7,0	7,3
Current account balance	% of GDP	-10,5	-15,5	-15,3	-11,5	-12,0	-11,7
Direct investment (FDI, net)	% of GDP	6,1	7,5	8,2	8,9	8,0	9,0
CPI	Ann. % ch	2,9	3,4	2,3	3,6	3,5	1,5
Interest rate (3 months)	% p.a.	5,92	6,24	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate LEK/EUR	Value	123,31	122,39	131,82	137,48	140,07	139,05
Nominal eff. exchange rate	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	-3,5	-5,5	-7,0	-3,1	-3,5	-1,2
General government debt	% of GDP	54,8	54,8	59,5	58,5	58,8	59,3

* Q1

Sources: Thomson Reuters/Ecowin, Eurostat

During 2011, net FDI inflows declined by 10%, reflecting the volatile global economic conditions, difficulties in neighbouring economies and the repatriation of capital which coincided with the fragile political climate in the country in the beginning of the year. As a result, FDI inflows covered some 65% of the current account imbalance, down from 78% in the previous year. Net FDI increased by some 30% in the first half of 2012, partly reflecting a favourable base effect caused by depressed inward investment figures in the corresponding period of the previous year. Higher FDI was reported in the oil extraction and banking sectors, the latter linked to bank recapitalisations. Although declining since 2010, Albania preserved a relatively comfortable level of international reserves at around 4.4 months of imports. Overall, the high current account deficit remains a source of vulnerability, especially in view of the potential adverse impact of the volatile global and regional economic situation on FDI and declining workers' remittances.

The government deficit increased from 3.1% of GDP in 2010 to 3.5% in 2011, as planned, although only after a mid-year budget re-balance. Total revenue growth decelerated to 1.8% and stood at 25.1% of GDP, reflecting a lower tax yield amid weak consumer expenditure and a sharp fall in non-tax receipts. Following a contraction in 2010, total expenditure increased by 3.7% to 28.6% of GDP in 2011 as a result of higher capital outlays and social transfers. The 2012 budget envisages a fiscal deficit of 3% of GDP, based on an assumed real GDP growth of 4.3%. In the period January-July 2012, total government revenue increased by 4%, compared with the same period of the previous year, but was 5.4% lower than planned, partly reflecting optimistic projections. Expenditure was broadly in line with plans, although payment arrears are a cause for concern. In July 2012, the government adopted the 2013-15 medium-term budget programme (MTBP) based on a downward-revised GDP growth rate of 3% for 2012. The MTBP aims at maintaining total public debt at 60% of GDP and net borrowing not exceeding 3% of GDP in 2012. Domestic borrowing remains the primary source of deficit financing. Overall, the budgetary framework remains weak at the planning stage, reflecting optimistic revenue projections, and also at the execution stage.

The public debt increased from 58.5% in 2010 to 58.8% in 2011, including 3.7% of GDP in government guaranteed debt. In the first half of 2012, public debt continued to increase, reaching 59.4% of GDP. Albania's relatively high and increasing public debt continues to show a short-term bias (50% of the debt has a maturity of one year or less) which requires frequent re-financing, although some three fifths of the debt is domestic. However, the bulk of the domestic debt is held by banks, which poses a risk if banks decide to reduce their exposure to government debt as a way to adjust their balance sheets. Any increase in interest rates would further limit the fiscal space. At such a high level, public debt remains a source of macro-financial vulnerability. Overall, the relatively high and increasing government debt remains a cause for concern. Further budgetary consolidation is needed to address this source of macro-financial vulnerability.

Some progress was made on improving the tax administration. The fiscal amnesty scheme, which aims to regularise undeclared assets and income, was introduced during the second half of 2011 and extended until the end of August 2012. Based on the preliminary results published in February, some € 10.7 million (0.1% of GDP) were collected as a result of the scheme. For the first time, the tax administration introduced an income declaration for taxpayers to file with the tax offices within 2012. The Laws on Excise was further aligned with the acquis while preparations for aligning the Law on VAT are advanced. The reference wages introduced in 2007 as a measure to reduce tax evasion will be removed while the frequency of profit tax payments by businesses has been reduced from a monthly to a quarterly basis. Despite these efforts, gaps remain in both revenue collection and administrative capacity. A fully-fledged tax compliance system is still lacking and enforcement continues to be weak, as does revenue collection at both central and, especially, local government levels. Some improvement was achieved in the VAT refund procedure during the first half of 2012; however, delays persist, putting an additional burden on businesses. Overall, some progress in the tax administration was achieved, but structural deficiencies remain.

Overall, macroeconomic stability has been maintained, as Albania was less affected by adverse external economic conditions. Monetary policy has successfully helped to keep inflation stable and anchor inflationary expectations. The high level of euroisation continues to limit the effectiveness of the monetary transmission channels. The relatively high and rising government debt limits the fiscal space and remains a source of macro-financial vulnerability. Essential structural reforms are still missing.

Interplay of market forces

According to official data, the private sector continues to account for 80% of GDP and employs about 82% of the labour force. No major privatisation took place during 2011. A law authorising the privatisation of Albpetrol — a state-owned oil company - was adopted by parliament in December, while a bidding deadline was fixed for September 2012. Preparations for the privatisation of the remaining state-owned shares of Albtelecom (16.75%) have started, although the bidding deadline was postponed to December. Privatisation of INSIG, a state insurance company, remains an objective for 2012, together with that of three hydropower plants owned by KESH, the state-owned electricity generation company. Regulated prices are estimated to account for 8% of the consumer price index (CPI). Some progress was achieved in the form of the adoption of a new water fee structure that, amongst other things, aims to align the tariff structure to ensure cost recovery. Overall, state involvement in the economy remains limited and mainly concentrated on energy, transport and water supply.

Market entry and exit

Business registration and licensing continued to perform well through the established network of one-stop shops. Some improvements were made in the business registration system by implementing the electronic commercial register for mergers and acquisitions and for the division and transformation of companies. A further reduction was recorded in the time and steps needed to start a business. E-procurement and e-tax filing are already in place and functioning. However, the procedure for granting building permits remains lengthy, delaying the revival of the ailing construction sector. The reform of inspectorates dealing with business and economic activities is at an early stage. No progress was made in the field of e-signature and no particular development can be reported towards implementation of the amended Law on Protection of Foreign Investors regarding property ownership.

No progress was made on reducing the timing and procedures for market exit, which remain slow. During 2011, about 3,900 requests for voluntary business closures were filed with the National Registration Centre (NRC). The structure of the Bankruptcy Supervisory Agency was approved in January 2012. The Agency's performance remains to be assessed.

Overall, Albania has made good progress on facilitating business entry into the market. The procedures for market exit remain slow and ineffective.

Legal system

The national strategy and action plan on property rights was adopted in June. Little progress was made in the fields of land registration and of restitution of property to former owners. The process of initial registration of immovable property has not yet been completed. Overall, the lack of secure property rights and the weak institutions remain causes for concern and further efforts are required to address these issues.

Businesses still face delays in court procedures and the perception of widespread corruption in the justice system persists. Some improvement was achieved in collateral execution with the introduction of a private bailiff's office. However, weak contract enforcement and execution of collateral remain major obstacles for businesses. Informal methods of contract enforcement, by-passing the legal system, are still widespread. The Law on the Establishment of Administrative Courts was adopted in parliament in May 2012. Overall, weaknesses in rule of law, incomplete reform of property ownership and corruption are continuing to have an adverse effect on the business environment.

Financial sector development

The financial system remains dominated by the banking sector, which accounts for 85% of GDP and comprises 16 commercial banks, which are all privately owned. The share of foreign ownership stands at some 90% of total assets. Despite the banks' dominance, the share of bank lending stood at around 43% of GDP, suggesting that there is significant scope for stronger financial intermediation. Credit growth increased by 11.7% in 2011, up from 8.6% a year earlier. During 2012, lending growth decelerated to 7% year on year by July. Outstanding loans to non-financial corporations, which account for the highest share of total bank loans, grew by 15.4% year on year in December 2011 but decelerated in the first half of 2012, reaching 9.7% in July. Lending to households was weaker during 2011, shrinking at an increasing rate in the first seven months of 2012, mainly on account of lower foreign currency credit. The growth in the stock of lek-denominated credit outpaced that of foreign currency lending during 2011. This trend continued through July 2012, reflecting both moderate demand for credit as well as more conservative lending policies by banks. Still, around 68% of the total credit outstanding is in foreign currency, of which more than half consists of un-hedged loans, suggesting that the banking system remains vulnerable in the event of unfavourable exchange rate movements. Deposit growth decelerated to 14.5% in 2011, from 15.5% a year earlier, and slowed down further to 10.6% year on year by July 2012. The banking sector's share of external borrowing in total liabilities followed an upward trend during 2011, increasing from 4.9% in December 2010 to 6.8% at the end of 2011, and then stabilised at 7% in the first half of 2012.

In general, the Albanian banking system remained capitalised and liquid. Following a decline in the first half of 2011, the capital adequacy ratio was restored to 15.6% by the end of the year, well above the minimum required. Nevertheless, non-performing loans continued to rise during 2011 and stood at 21.21% of total loans in June 2012. In response, the banking sector raised provisions from 10.8% of total loans at the end of 2011 to 12.2% in the second quarter of 2012 which, in turn, had an adverse impact on profitability. The process of execution of collateral has been slow, partly reflecting a weak judicial process, delaying the cleaning-up of banks' balance sheets.

Several precautionary steps to strengthen the stability of the banking sector were adopted in 2011. The Law on Banks was amended in November 2011, giving the BoA new powers to ask branches of foreign-owned banks to convert into subsidiaries. In June 2012, the BoA adopted regulations on the creation of the 'bridge bank' facilitating a resolution in the event that a bank runs into difficulties. Furthermore, the regulatory and supervisory framework has been enhanced by means of more conservative regulatory limits, differentiated by currency, on banks' liquidity indicators and guidelines on the obligations of the commercial banks to meet the minimum reserve requirements. Parliament adopted some amendments to the law on deposit insurance in July 2012. Overall, the banking sector remains well-capitalised and liquid. However, the high level of non-performing loans is a cause for concern.

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

Existence of a functioning market economy

Macroeconomic stability was maintained, as Albania was less affected by adverse regional and global economic conditions. Although positive, GDP growth decelerated and remained below historical averages. Despite slightly higher employment, structural imbalances in the labour market and the current account remain high. The government deficit worsened amid weak revenue and higher expenditure and, as a result, public debt increased. The relatively high level of public debt combined with its short-term structure remains a source of macro-fiscal vulnerability. The planned privatisation programme stalled. Some reforms to facilitate market entry were introduced, but efforts to ensure an orderly market exit for businesses slowed. Weaknesses remain in the rule of law, particularly in contract enforcement and property rights. Overall, although some progress was made on establishing a functioning market economy, Albania needs to consolidate its public finances and reduce the relatively high public debt, further bolster governance, enhance labour market performance, provide protection for property rights and strengthen the rule of law.

Human and physical capital

Public expenditure on education is estimated to have reached 3% of GDP in 2011, while the budget allocation planned for 2012 is slightly lower at 2.8%. Spending on education will aim to improve the overall quality of service delivery at all levels, with particular focus on achieving the OECD standards on the teacher/student ratio, adding 400 teachers and increasing the number of science laboratories. A campaign to modernise textbooks and syllabuses to bring them more into line with labour market needs has been started. No developments can be reported with regard to increasing public spending on research and development (R&D). The budget for R&D remains quite low, at 0.04% of GDP in 2012, similar to that allocated in 2011. There is a lack of scientific research institutions and collaboration between universities and industry on R&D is weak. The ‘brain gain’ system of bonuses given to employees of the public administration who graduated abroad restarted in 2012 after being suspended in 2011.

According to provisional official data, investment stood at 33.1% of GDP in 2011, slightly lower than in 2010. Public capital outlays are estimated to have reached 6.2% of GDP in 2011 and are expected to be slightly lower in 2012 at 5.8%. Health, education, infrastructure and agriculture remain priority areas within public investment. However, the main public investments (about 55% of total public investment) are concentrated on road infrastructure. Insufficient road maintenance and illegal construction along roads remain causes for concern. Rail transport remains underdeveloped. Further investment in infrastructure is needed in order to attract investors and stimulate tourism. Albania’s electricity generation remains vulnerable due to an over-reliance on hydropower plants. Unfavourable weather conditions seriously dented electricity output, which fell by 48% in 2011. To avoid load shedding, electricity was imported, which had a negative impact on economic growth and the trade balance. In addition, the electricity system needs significant investment to reach the requirements related to security of supply. An unreliable supply of electricity is an obstacle for businesses, as it disrupts production and pushes up costs. In an effort to improve generation capacity to meet demand, the government continued to issue concession permits in 2011 for construction of new hydropower plants. Nevertheless, the number of concessions that are operational remains low, reflecting mainly a weak legal framework. Private plant operators generate only 2% of the total supply. Overall, higher levels of investment are needed to make the Albanian economy competitive on regional and international markets. Redirecting more expenditure towards growth-promoting categories, such as human capital and productive physical infrastructure, including the supply of electricity, would boost long-term growth.

Sectoral and enterprise structure

The relative shares of agriculture, industry and services in gross value added (GVA) broadly unchanged in 2011 from the previous year. Services remain the main contributor to Albania’s gross value added GVA at roughly 60%, with trade, hotels and restaurants accounting for the bulk of this sector. Agriculture’s share in GVA increased to some 21% at the expense of construction which fell to slightly less than 11%. The decline in manufacturing’s share in GVA was offset by higher gross value added from the extractive industries. Agriculture remains the largest employer with 54% of total employment in the first half of 2012. Inward processing performed well during 2011 but energy production contracted.

Albania's manufacturing base remains concentrated around three main sub-sectors which accounted for some 83% of total exports of goods in 2011 and which are either dominated by low value-added products or vulnerable to fluctuations in global commodity prices: textiles and footwear (32%), minerals, fuel and electricity (30%) and building materials (21%).

Weak tax and expenditure policies and poor law enforcement, including in the fight against corruption, have been fuelling a sizeable informal sector. Some steps were taken during the year to address informality, including the extension of use of fiscal devices (cash registers) across the country. However, implementation remains a challenge to the administration. The informal economy continues to impede fair competition on the market, and strengthening law enforcement remains a government priority. SMEs continued to benefit from credit support schemes and the European Fund for South-East Europe (EFSE). Overall, the structure of the economy remained unchanged. While some measures were taken to combat the sizeable shadow economy, informality remains a challenge. Albania's production base lacks diversification in terms of both sectors and export markets, leaving the economy vulnerable to industry-specific shocks.

State influence on competitiveness

Subsidies remained almost unchanged compared with the previous year, at 0.3% of GDP in 2011. For 2012, the budget projects a decline in subsidies to € 11.4 million or about 0.1% of GDP. Subsidies are granted to a limited number of sectors, namely railways, energy and water supply as well as horizontal State aid schemes. Financial viability of the electricity sector remains elusive as losses in the electricity network and distribution deteriorated further in 2011, bill collection rates continued to decline, while tariffs are still below cost-recovery putting undue pressure on public finances. The cost of importing electricity to compensate for the fall in electricity output was not transferred to end-users, prompting the government to provide an additional € 14.2 million in loan guarantees in January 2012 to KESH. KESH's finances remain exposed to the outcome of a netting-off agreement reached in March 2012 with CEZ, the power distribution company. This agreement is part of the implementation of the protocol on partial financial settlement of outstanding mutual debts signed by the Albanian authorities, CEZ and the Energy Community Secretariat (ECS) in November 2011. It has not yet been fully implemented and the dispute between KESH and CEZ over outstanding mutual debts remains unsolved. Overall, state intervention remains limited. However, the impact on the public finances of the lack of diversification and full financial viability of the electricity sector and its high reliance on climate conditions remains a concern.

Economic integration with the EU

The openness of the Albanian economy continued to increase in 2011. Trade in goods and services stood at almost 90% of GDP in 2011, up from 86% a year earlier. Despite a decline in 2011, the EU remains Albania's main trading partner. Around 80% of Albania's total foreign sales of goods are directed to the EU, with textiles and footwear accounting for more than half of total exports. Around 65% of goods imports originate from the EU. Despite the uncertain economic conditions in some EU Member States, exports to the EU increased by roughly 8.5% year on year in the January-July period. A significant increase in both exports and imports to and from CEFTA countries was recorded in 2011. During 2011, trade in goods with CEFTA grew by roughly 33%, accounting for 17.2% of total exports and 13.5% of total imports. The EU also remains the main source of inward investment in Albania, although its share in total FDI stock has declined in the last four years.

Following a period of heightened price competitiveness pressures, the real effective exchange rate (REER) fell significantly in 2010, mainly due to the depreciation of the lek in nominal effective terms. The REER remained generally stable during 2011 and in the early months of 2012. Cost competitiveness has also improved since 2010, with estimates pointing to a sharp deceleration in unit labour costs helped by higher productivity growth. Overall, the EU remained Albania’s leading trading and investment partner. Trade with CEFTA countries increased.

7.3. CONCLUSIONS

Albania maintained macroeconomic stability. GDP growth, driven mainly by domestic demand, decelerated but remained positive at 3.1% in 2011. Economic activity has been stagnant in the first quarter of 2012 amid weather related power disruptions. Underperforming revenue and higher expenditure led to a rise in the government deficit and consequently higher public debt. Structural reforms lost steam in part due to the fragile domestic political dialogue. Monetary policy remained sound and kept inflation within the target range. Weak enforceability of contracts and the rule of law, inadequate levels of infrastructure and human capital, as well as the informal economy continue to hamper economic development.

As regards the economic criteria, Albania made some further progress towards becoming a functioning market economy. Albania should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it accelerates and deepens structural reforms, including by reinforcing the legal system and strengthening physical and human capital.

Broad agreement on the key essentials of a market economy was maintained despite the often polarised political context. The Albanian economy continued to grow, albeit at a slower pace and despite the persistent unfavourable economic conditions in its main trading partners. Monetary policy has successfully helped to keep inflation stable and anchor inflationary expectations. Labour market performance slightly improved. State involvement in the economy and the level of subsidies have remained limited. The banking sector is well-capitalised and liquid. Some progress was made to further facilitate market entry.

However, the fiscal deficit increased in 2011, leading to a further rise in the relatively high public debt which continues to show a short-term bias. The persistently high current account deficit is a source of vulnerability. Unemployment continues to be persistently high. Implementation of bankruptcy procedures is incomplete. Weaknesses in the rule of law hinder the enforceability of contracts while pending issues in the area of property rights hamper investment and business environment in general. The informal sector and weak tax collection remain a challenge. The high and increasing level of non-performing loans in the banking system is an issue of concern. Investment in human capital and infrastructure remain inadequate. The lack of diversification of the production base in terms of sectors and export markets leaves the economy vulnerable to external shocks.

8. 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.

8.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Economic policy essentials

The long-lasting political stalemate following the October 2010 general election had a negative impact on the country's economic and fiscal policy. The delays in adoption of the 2011 and 2012 State-level budgets and of the Global Frameworks for Fiscal Policies for the periods 2012-2014 and 2013-2015 increased the uncertainty over the short- and medium-term fiscal path. Despite the steps taken by the new central government as of February 2012, the consensus between the authorities at different government levels on the economic policy essentials has weakened. The Stand-By Arrangement (SBA) negotiated with the International Monetary Fund (IMF) in 2009 has, de facto, been non-functional since October 2010, when the last programme review was completed. The country was able to withdraw only about 1/3 of the funds before the SBA expiration. In September 2012, the IMF Board approved a new two-year SBA aimed at supporting the country's efforts to counter the effects of the worsening external environment and tackle external and domestic vulnerabilities. The budgetary support planned by the World Bank has been delayed mainly due to the lack of tangible outcomes of legislative reforms in the area of cash transfers. In March 2012 the authorities submitted – after a significant delay – their sixth Economic and Fiscal Programme, covering the period 2012-2014. In the absence of a medium-term fiscal framework at country level, the programme remains fragmented and does not present a coherent formulation of economic and fiscal policies. Overall, the consensus on economic and fiscal policy essentials has weakened and hampered progress in reforms at country level.

Macroeconomic stability

In 2011, the economic recovery continued with real GDP growth accelerating slightly to 1.3%, as compared to 0.7% a year earlier. Domestic demand revived, supported by a relatively stable inflow of remittances and slightly accelerating credit growth. Both private consumption and private-sector investment registered positive growth rates after the decline in 2009-2010. After being the main contributor to the expansion of the economy in 2010, external demand weakened in the second half of 2011 and export growth moderated significantly. At the same time, import growth accelerated – spurred by the recovering domestic demand –, thus resulting in a negative contribution of net exports to growth. Industrial production rose by 5.6% in 2011, up from 1.6% in the previous year, driven by export-oriented industries. However, the indicators available for 2012 suggest that the economic recovery stalled, negatively affected by the worsened external environment. Industrial production fell by 6.5% year on year in the first seven months of the year, while exports of goods dropped by 4.3%. Per capita income, measured in purchasing power standards (PPS), decreased to 29% of the EU average in 2011 from 30% in 2010. Overall, economic recovery gained some momentum in 2011 but this positive trend was reversed in early 2012.

After a crisis-led adjustment in 2009-2010, the current account deficit soared from 5.7% of GDP in 2010 to 8.8% in 2011. This deterioration was mainly driven by the expansion of the trade deficit, surging by 12.3% year on year to 27.9% of GDP. Export growth almost halved to 15.6%, while the recovery of domestic demand triggered an acceleration of the growth of imports to 14%. Surpluses in the services and income accounts decreased by 4.1% and 22%, respectively, thus also contributing to the higher current account deficit. At the same time, the net current transfers – covering almost half of the trade deficit – grew only slightly by 2.5%, thus only partially offsetting the negative developments in the goods, services and income balances. In the first quarter of 2012, the current account deficit widened further by 64.6% year on year due to faster expansion of the trade gap. Exports fell by 9.6% year on year, negatively affected by the economic downturn in the EU, while the imports still grew, even though at a significantly reduced rate. The current account deficit was financed mainly by external borrowing and, to a lesser extent, by foreign direct investment (FDI). The stock of official foreign exchange reserves decreased by 0.5% in 2011 and fell further by 4.1% year on year in the first seven months of 2012, though still covering around five months of imports. Bosnia and Herzegovina's external public debt increased by 5.9% to 26.1% of GDP in 2011, while external private debt reached 33.1% of GDP. In the first half of 2012, the external public debt rose further by 5.1% year on year. Public international creditors account for 90% of the country's external public debt. The largest creditor remains the World Bank group. A large part of the debt is contracted on concessional terms with the average interest rate of all debt being at only 1.6%. Overall, external imbalances have widened again after the sharp crisis-led contraction in 2009-2010, thus indicating that the adjustment was just temporary and not structural.

Table 8.1:
Bosnia and Herzegovina - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	6,1	5,6	-2,9	0,7	1,3	N.A.
Private consumption	Ann. % ch	10,9	10,3	2,3	-0,9	3.0e	N.A.
Gross fixed capital formation	Ann. % ch	34,3	22,8	-17,7	-9,9	9.7e	N.A.
Unemployment	%	42,9	40,6	42,7	42,7	43,8	44,0
Employment	Ann. % ch	4,4	2,7	-2,8	1,9	-1,6	-0,8
Wages	Ann. % ch	9,8	16,6	8,2	1,1	4,4	2,1
Current account balance	% of GDP	-10,7	-14,0	-6,3	-5,7	-8,8	-9.4*
Direct investment (FDI, net)	% of GDP	13,4	5,3	1,4	1,1	2,3	2.7*
CPI	Ann. % ch	1,5	7,4	-0,4	2,1	3,7	2,2
Interest rate (3 months)	% p.a.	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Stock markets	Index	4.330	2.251	1.038	954	979	761
Exchange rate BAM/EUR	Value	1,94	1,94	1,94	1,93	1,93	1,93
Nominal eff. exchange rate	Index	100,3	100,1	96,3	96,5	95,7	95.0*
General government balance	% of GDP	1,2	-2,2	-4,4	-2,5	-1,3	N.A.
General government debt	% of GDP	18,1	17,1	21,8	25,6	26,1	25,5

* Q1
Sources: Thomson Reuters/Ecowin, Eurostat

Labour market conditions remained weak. The average unemployment rate reached 27.6% in 2011, as compared with 27.2% a year ago. Employment fell by 1.6% in 2011 and went further down in the first six months of 2012. The highest decline in employment was registered in construction, agriculture and manufacturing, whereas some employment growth was witnessed in real estate, mining and quarrying and financial intermediation. The number of employees in the public administration continued to rise throughout 2011 and the first half of 2012, thus further increasing the size of the already large public sector. The Labour Force Survey (LFS), conducted annually in April/May following the International Labour Organisation (ILO) methodology, showed an increase in the unemployment rate to 28% in 2012 from 27.6% a year earlier. Unemployment was particularly high among the young population (63.1% for people aged between 15 and 24, according to the LFS). The officially registered unemployment rate climbed up to 43.8% in June 2012, compared with 43.1% a year before. The very high unemployment rate and the sizeable difference between the registered and survey-based labour figures point to the existence of a fairly large informal labour market and significant structural rigidities, such as the high rates of social security contributions and poorly targeted social transfers. Average monthly nominal gross wages increased by 4.4% in 2011, but wage growth has been moderating since the beginning of 2012. Adjusted for inflation, the average gross wage rose marginally, by 0.7%, in 2011 before the trend turned negative, at -1.6%, in June 2012. Overall, labour market conditions have remained weak. Unemployment is very high and structural rigidities continue to hamper job creation.

Average annual inflation reached 3.7% in 2011, compared to 2.1% in 2010. The highest increases were registered in transport and food prices, reflecting international price developments. The rising overall price level in 2011 was also driven by an increase in excise duties on tobacco and alcohol. Inflation moderated in the first seven months of 2012, dropping to 1.4% in July, pushing the 12-month moving average inflation rate down to 2.8%. The growth of food and transport prices slowed down, which were the main factors behind the lower inflation. The monetary policy of the Central Bank continued to be conducted under a currency board arrangement, with the euro as the anchor currency, enjoying a high level of confidence and credibility. Monetary policy settings have remained unchanged since February 2011, when the minimum reserve requirement for short-term deposits was lowered from 14% to 10%. The growth of money supply moderated in the course of 2012 and monetary aggregate M2 increased by 4.3% year on year in July, as compared with a 5.8% rise in 2011. Overall, the currency board has continued to function well and monetary and financial stability have been preserved while inflation has moderated.

The consolidated budget deficit reached 1.3% of GDP in 2011, compared with 2.5% in 2010. Fiscal consolidation was achieved partly as a result of rising revenue, fuelled by the economic recovery and increases in tax, contribution and excise rates. The share of general government in GDP remained high, with government expenditure at approximately 45.8% of GDP and revenue at about 44.6% in 2011. Tax revenue increased by 7% due to higher economic activity, an increase in the personal income tax as of February 2011 in Republika Srpska and a rise in excise duties on tobacco which counteracted the continuous reduction of duties and tariffs as set out in the Interim Agreement on trade with the EU. Collected contributions – accounting for over 1/3 of the overall revenues – rose by 5.9%, partly because of the increase in contribution rates in Republika Srpska as of 2011. On the expenditure side, purchases of goods and services plummeted by 19.5%, thus creating some fiscal space. However, expenditures on social benefits and wages increased by 14.9% and 5.3%, respectively, thus further increasing their already high shares in overall expenditure. The higher wage bill was partly caused by the income tax changes in Republika Srpska. Capital expenses surged by 21.6%, although from a very low base following the contractions in recent years. In the first half of 2012, the repercussions of the worsened external environment were increasingly felt in public finances. Tax revenue fell by 0.8% year on year reflecting the downturn in economic activity, while most expenditure categories increased in year on year comparison. Overall, some fiscal consolidation has taken place, but the quality of public finances remains low.

The transparency, sustainability and reliability of public finances in Bosnia and Herzegovina were seriously undermined by the long delay in adoption of the State-level budget and of the Global Frameworks for Fiscal Policies for 2012-2014 and 2013-2015. The State-level budget for 2011 was not adopted until February 2012, while the one for 2012 was approved in May. Temporary financing arrangements were in place throughout 2011 and the first two quarters of 2012. The Parliament of Republika Srpska endorsed the Entity's 2012 budget in December 2011, planning a 4% rise in total spending (compared with the revised 2011 budget), while the 2012 budget of the Federation – projecting 11% growth in nominal expenditure – was approved in January 2012. Both Entity budgets were adopted in the absence of a medium-term fiscal framework, in violation of the country's legal framework for the second consecutive year. In March 2012, the Fiscal Council agreed an expenditure ceiling and a fixed revenue allocation from the Single Account for the State-level institutions for the period 2012-2014, thus creating the necessary preconditions for drafting a comprehensive medium-term fiscal strategy. In June 2012, the authorities agreed on the fiscal framework for the period 2013-2015, thus allowing for the timely launch of the 2013 budget preparation process. In September 2012, both Entity budgets have been revised slightly in accordance with the newly reached agreement with the IMF. Total planned spending of Republika Srpska has been corrected downwards by 0.8%, while the Federation has reduced its budget expenditure envelope by about 2%, when adjusted for financing items and reclassification effects. The authorities have reached an agreement on the settlement of disputed indirect tax revenue amounts through end-2011. However, an agreement on a permanent formula for allocation of indirect tax revenue to the State, the Entities and the Brčko District is still pending. In Republika Srpska, the new Pension Law, adopted in December 2011, should improve the long-term sustainability of the Entity's public finances, while in the Federation a special working group has been established to tackle this issue and to define a reform strategy by the end of 2012. Overall, the sustainability and credibility of fiscal policy in Bosnia and Herzegovina suffered from the delayed adoption of the State-level budget and of a medium-term fiscal strategy.

General government debt, both domestic and foreign, increased by 6% and stood at 39.5% of GDP at the end of 2011. External debt accounted for 26.1% of GDP and domestic debt for 13.3%. Domestic public debt is managed and served by the Entities. Both Republika Srpska and the Federation started issuing short-term treasury bills and long-term government bonds in 2011 to finance their cash-based budget deficits. For the time being, the offers have met relatively high demand and secured relatively favourable conditions. Overall, even though the debt-to-GDP ratio is still relatively moderate, its upward trend needs to be monitored carefully.

The quality of the policy mix has worsened, thus challenging macroeconomic stability. The currency board arrangement continues to enjoy a high level of confidence and credibility, but the weakened budget planning and lack of fiscal coordination severely threaten the transparency, reliability and sustainability of public finances and are a serious impediment to short- and medium-term economic planning. Overall, financial and monetary stability have been preserved, but the worsening quality of budgetary processes is hampering the conduct of macroeconomic policies.

Interplay of market forces

The private sector's share in GDP is estimated to have remained stable at around 60% of GDP in 2011. There has been no further progress with the privatisation agenda. In Republika Srpska, some 69% of the initial stock of State-owned capital intended for privatisation had been sold by September 2012, unchanged from a year earlier. In the Federation, none of the ten companies included in the 2012 privatisation plan has been sold. About 58% of the initial stock of State-owned capital intended for privatisation remains State-owned. Most prices are liberalised, even though a number of regulated prices remain (e.g. for utilities). Overall, the planned privatisation process has not advanced for the fourth consecutive year.

Market entry and exit

In 2011, the time needed to start a business was reduced from 55 to 40 days, on average. The time required to obtain a construction permit was shortened significantly from 255 to 181 days. However, companies are still required to register in both Entities before they can do business in the whole country. In Republika Srpska, the new Law on Crafts and Entrepreneurship simplified business registration procedures for entrepreneurs. The Law on Courts was also amended in order explicitly to give jurisdiction over company registration, bankruptcy proceedings and commercial disputes to five regional commercial courts. In the Federation, the second stage of the 'legislative guillotine' project to reduce the administrative burden has been completed. A total of 27 legal acts were adopted in various ministries to streamline 352 business-related administrative procedures by December 2011. In the first half of 2012, alongside the worsened external environment and decreased economic activity, the number of newly registered companies dropped by around 12% year on year. Overall, some limited improvements have been made to the business environment but significant administrative barriers remain for private-sector development.

The legal system

No substantial improvements can be reported in the complex legal system in Bosnia and Herzegovina. Even though the standard of legislation is relatively high in some areas, implementation and application of laws in practice is often poor due to the weak enforcement capacity of key institutions. The rule of law is weak and the judicial system often does not function efficiently, is subject to obstruction by the parties and does not cover commercial activities adequately. Enforcement of commercial contracts remains a lengthy process, which involves 37 procedures and takes an average of 595 days. Overall, weak rule of law, corruption and unreliable contract enforcement continue to impair the business environment.

Financial sector development

The banking sector continued to dominate the financial system of Bosnia and Herzegovina, with an 83% share in the total assets in 2011. The share of claims on the private sector in relation to GDP decreased marginally year on year to around 55% in July 2012. Twenty-nine banks are operating in the country, out of which twenty-eight are privately owned and one is majority State-owned. Two banks are under provisional administration. Twenty-one banks are under foreign ownership, accounting for slightly below 90% of the total banking system assets in 2011. The five largest banks accounted for 56.3% of the total assets of the banking sector. Banking sector assets rose marginally, by 0.1%, in 2012 (July compared with December 2011), accounting for approximately 86% of GDP.

The financial position of domestic banks has improved. After an aggregate net loss of some € 63.6 million in 2010, the banking sector finished 2011 with an aggregate net profit of € 72.6 million. After the slight improvement at the end of 2011, the quality of the loan portfolio has been deteriorating again since the beginning of 2012. The share of non-performing loans fell slightly to 11.9% in the fourth quarter of 2011, but rose to 12.6% in the second quarter of 2012. The capital adequacy ratio increased from 15.3% in the third quarter of 2011 to 16.8% in the second quarter of 2012, comfortably above the legal minimum of 12%. Banking profitability improved slightly in the first half of 2012. The return on average equity increased from 3.4% in the third quarter of 2011 to 4.2%, while the return on average assets grew from 0.4% to 0.5%. However, liquidity indicators deteriorated during the same period with the ratios of liquid to total assets falling from 27.2% to 24.8% and of liquid assets to short-term financial liabilities from 47.5% to 43%. Twenty-six banks are participating in the deposit guarantee scheme. Its coverage level remained unchanged at around € 18,000. Overall, despite the relatively high non-performing loan ratio, financial stability was safeguarded.

Annual credit growth accelerated from 3.1% in 2010 to 5.3% at the end of 2011 and moderated slightly to 4.3% in July 2012, with total loans accounting for about 60% of GDP. However, loans to private enterprises have been stagnating since the beginning of 2012, while those to the government surged rapidly by over 40% year on year. Loans to households increased by 5% year on year up to the end of July. The recovery of deposits continued though at lower rates. Total banking deposits reached 49.8% of GDP in July. Households remained the main contributors to this development, increasing their savings by 9.5%, while the corporate sector raised its deposits only slightly by 2.7%. As a consequence of these developments, the loans-to-deposits ratio climbed from 118.2% in October 2011 to 121.3% in July 2012. The spread between the average loan and deposit interest rates of commercial banks decreased further by 17 base points from 7.43 percentage points in September 2011 to 7.26 percentage points in early 2012, mainly due to lower lending rates. This level points to still high intermediation costs. Overall, the efficiency of financial intermediation has continued to increase slightly and credit activities have been gaining strength but there are signs that the government is crowding out private investments.

After a slight recovery in early 2011, stock market indices have been on a downward trend. The main index of the Sarajevo Stock Exchange lost 7.9% in the first eight months of 2012, while that of the

Banja Luka Stock Exchange fell by 6.3%. The cumulative turnover shrank by 23.5% year on year in the period from January to August 2012. The combined market capitalisation declined to about 30% of GDP from around 44% in 2011. The insurance sector remained small, accounting for approximately 1.9% of GDP in 2011. The annual growth of premiums accelerated slightly to 3.4%, from a 2.9% annual rise in 2010. The market was dominated by the non-life insurance segment, which accounted for 83.6% of the total. Twenty-five companies were operating on the market in 2011, unchanged from the previous year. Overall, financial intermediation by the non-banking sector remained shallow.

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

Existence of a functioning market economy

External imbalances have increased and the quality of public finances remains low, even though some fiscal consolidation has taken place. The slow pace of economic restructuring, especially in the Federation, combined with the prevailing obstacles to private-sector development and the structure of budgetary expenditures - increasingly dominated by current spending at the expense of growth-enhancing activities - continue to undermine a more growth-oriented allocation of resources and any strengthening of domestic sources of growth. Unemployment remains very high. Progress towards creating a single economic space within the country – which is a key European Partnership priority – has been limited. Overall, the functioning of market mechanisms remains hampered by the large government sector, characterised by low spending efficiency and sizeable interference in the economy.

Human and physical capital

Education and training policy falls within the responsibilities of the Entities and Cantons. Information and statistics on human capital is scattered and scarce, thus preventing effective policy-making. Progress in the field of education has been limited. A new coordination format for education reform has been agreed. However, the mismatch between the qualifications needed on the labour market and the profile of graduates coming out of the education and vocational training systems adds to other structural weaknesses, such as high social security contributions and poorly targeted social transfers, and remains a concern. Cooperation between the education system and employers is still weak. Enrolment rates in higher education decreased slightly in the 2011-2012 academic year. Participation in the labour market is still very low, with an activity rate of 44% in 2012, remaining unchanged in year on year comparison. Overall, the proper functioning of the labour market continues to be hampered by structural rigidities and the weak performance of the education and training system.

The investment-to-GDP ratio remained at a relatively low level of about 20% in 2011, broadly unchanged from a year ago. Net FDI flows more than doubled in 2011 – albeit from a very low level – , reaching 2.3% of GDP. The banking sector accounted for a significant part of the net FDI inflows, while some increase was also evident in retail trade and real estate. A number of projects are underway to upgrade road and railway infrastructure. Maintenance and upgrading of roads continued, but progress was slow. The Federation Parliament adopted the spatial plan for the route of transport corridor Vc in the Entity in December 2011. Overall, infrastructure improved slightly, but still requires repairs and modernisation.

Sector and enterprise structure

Market liberalisation remains insufficient in many sectors as most utility providers still do not apply market prices. Although the utility market was opened for non-household consumers, they have little incentive to change suppliers, as regulated tariffs are still below market prices. No progress has been made on unbundling electricity networks. Progress towards a competitive telecommunications market has been limited. The three incumbent operators continue to act as de facto monopolies in their geographical areas. Their combined share of the fixed telephony market added up to 85% for international calls and 98% for national callsin 2011. New licences were granted for internet services and network operators. The level of broadband internet access has increased further but still remains at relatively low level of slightly over 11%. The Railways Regulatory Body introduced a set of regulations, aiming at reaching compliance with the EU directives. Overall, limited progress was achieved on liberalisation of network industries.

There were no major shifts in the sectoral structure of the economy in 2011. Services accounted for 68.4% of gross value added (up from 68% in 2010), industry and construction for 26.7% (26.8%) and agriculture for 8.4% (8.6%). The traditionally high share of public administration, education and health increased further to 23.1%. The large informal sector which is fuelled by weaknesses in tax and expenditure policies and in law enforcement, including the fight against corruption, remains an important challenge. Overall, there have been no major changes in the structure of the economy. The informal sector is an important challenge.

State influence on competitiveness

No progress has been made towards reducing the state's influence in the economy. In 2011, direct budget subsidies to industry and agriculture decreased to 1.6% of GDP from 1.9% in 2010. However, in the first half of 2012, they increased by 28.4% year on year. State-level legislation on State aid has been adopted, but a State aid authority has not been established and a State aid inventory has not been compiled. Overall, State aid remained high and the state continued to influence the economy through state-owned monopolies.

Economic integration with the EU

Bosnia and Herzegovina remains an open economy. Total trade (the sum of the volume of exports and imports of goods and services) increased further to 93.2% of GDP in 2011, as compared with 84.2% in 2010. The EU continues to be the country's largest trading partner, with shares of 58% of total exports and 46.6% of total imports in the first eight months of 2012 (goods only). While the share of exports to the EU has increased somewhat, the share of imports from the EU has decreased slightly. The other main trading partners were, once again, the countries of the CEFTA region, which account for 32.2% of exports and 25% of imports. In 2011, the real effective exchange rate based on the country's 20 largest trading partners appreciated marginally by 0.1%. Overall, the level of trade integration with the EU remained high.

8.3. CONCLUSIONS

The economy of Bosnia and Herzegovina grew by 1.3% in 2011, supported by reviving domestic demand and – to a lesser extent – still growing external demand. The recovery process was reversed in early 2012 as a consequence of the worsened economic environment. Unemployment remained at very high levels. Some fiscal consolidation took place as a result of increased revenues and some expenditure cuts. However, the quality of public finances remained low and the fiscal sustainability was severely hampered by the protracted adoption of the State-level budget and of a medium-term fiscal strategy. The weakened consensus on economic and fiscal policy essentials had a negative impact on reforms at the country level. A new two-year IMF Stand-By Arrangement has been agreed to support the country's efforts to counter the effects of the worsening external environment and tackle external and domestic vulnerabilities.

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

Financial and monetary stability was preserved, while inflation moderated. The currency board arrangement continued to enjoy a high degree of credibility. Credit growth continued – although marginally decelerating –, thus allowing for domestic demand recovery. Trade activities have increased further and the level of trade integration with the EU and countries in the region remained high. Some limited improvements in the business environment can be reported, in particular regarding accelerated business registration.

However, the delays in the adoption of the 2011 and 2012 State-level budgets and the Global Frameworks for Fiscal Policies 2012-2014 and 2013-2015 severely hampered the sustainability and credibility of fiscal policy in Bosnia and Herzegovina. The quality of public finances remained low with high shares of current expenditures to GDP. The repercussions of the worsened external environment are increasingly affecting public finances since 2012, with both the government borrowing and the debt rapidly increasing. This borrowing is to a certain extent crowding out private investors. External imbalances, in particular the foreign trade gap and the current account deficit, have been rising. Privatisation, restructuring of public enterprises and the liberalisation of network industries did not advance. The productive capacity and the competitiveness of the economy remained weak as domestic sources of growth were not adequately exploited. Labour market conditions remained poor and structural rigidities such as the high rates of social contributions and poorly targeted social transfers continued to hamper job creation. Unemployment continued to be very high and the participation rate is very low. The business environment is affected by administrative inefficiencies and the weak rule of law. The informal sector remains an important challenge.

9. KOSOVO*

Respect for market economy principles should form the basis for domestic and external policies. This entails a stable macroeconomic environment supported by a stable institutional framework, a comprehensive liberalisation of prices, and trade and current account transactions. The creation of a strong private sector through de-monopolisation and privatisation and the establishment of a prudently managed financial sector are also important factors. These policies should be supported by a stable and transparent legal and regulatory framework.

Kosovo has implemented the initial essential reforms towards establishing a fully functioning market economy. This is sufficient to establish contractual relations with countries from the Western Balkans, as stated in the Council Conclusions of April 1997.

9.1. ECONOMIC SITUATION AND STABILITY

9.1.1. Economic situation

Economic policies have been volatile over the past three years. Kosovo has undergone a period of marked fiscal expansion, which boosted economic growth and budget revenue. At the same time, this has increased external imbalances and economic vulnerabilities. Since the second half of 2011, fiscal consolidation steps have been undertaken in reaction to existing financial constraints. The government has also advanced reforms to improve the economy's regulatory business environment. There is broad consensus in the society on pursuing market-based policies. At the same time, corruption and informal business practices are still widespread, and remain important challenges to economic development. In this context, the rule of law needs to be strengthened.

Economic stability has largely been preserved. Kosovo's fully euroised economy has been relatively insulated from the global economic crisis, due to its limited integration in the international economy. Banks' lending is funded from domestic sources and the sector remains well capitalised and profitable. After failing to implement an IMF Stand-By Arrangement (SBA) in 2010, economic policies have recently been anchored by a Staff-monitored programme and a new SBA, aiming at restoring fiscal sustainability. Nevertheless, the economic situation is challenging. The economy provides few employment opportunities. External imbalances are high and economic activities are predominantly concentrated in the services sector, in particular retail and wholesale trade. Reliance on remittances and direct or indirect support of donors has been declining but remains significant.

The economy expanded on average by around 4% over the last three years. Growth is expected to have accelerated to 5% in 2011, mainly driven by domestic demand with strong increases in government consumption and investments. Exports of goods and services have also increased, but still cover only about a third of total imports. The production base remains extremely narrow. Agriculture, mostly semi subsistence, contributes about 17% of the value added in the economy. Manufacturing is limited and concentrated in the extraction of raw materials, which also dominate the exports of goods.

Data on employment is scarce and often not reliable. Employment and activity levels are extremely low. Estimates suggest that only about a quarter of the working age population have a job and only one woman out of eight is employed. Unemployment is above 40% and especially pronounced among the youth – more than 70% of whom are without a job. About 80% of all unemployed have been without a job for more than a year, revealing deep structural challenges. There has been relatively high growth over the last three years, but job creation is lagging and not enough jobs are created to reduce labour market pressures. In addition, the economic structure is largely based on sectors relying on low

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

skilled labour. Most of the labour force is unskilled or semi-skilled, implying potential constraints for businesses trying to develop in sectors with higher value added. High remittances inflows have an important impact on the labour market, as they tend to increase the reservation wage and reduce incentives to work. The lack of perspective for a job, especially among the young population, is putting strains on social cohesion and encourages emigration.

Inflation has been volatile, moving from a deflation of -2.4% in 2009 to an average annual inflation of 7.4% in 2011. Food and energy prices are by far the biggest contributors to inflation dynamics. Domestic prices are highly dependent on international commodity price movements. Food prices have a share of about 35% in the consumer basket, marking a decline over the recent years . After increases ranging between 30-50% in 2011, the net monthly average wage in the public sector reached € 368 in December 2011. Public sector wages have risen more than 60% altogether in the last three years, far surpassing productivity gains. There is scarce information about private sector wages but a survey done by the Kosovo Business Alliance shows that their average levels are below public sector wage levels.

Kosovo uses the euro as a legal tender and the Central Bank has limited policy instruments. Banking supervision and conservative lending policies of the commercial banks have been key in preserving financial sector stability. Credit is financed out of domestic deposits and banks observe an informal 80% threshold for the loans-to-deposits ratio. As part of the agreement with the IMF, the central bank and the Ministry of Finance have established a special reserve fund for providing emergency liquidity assistance to the financial sector.

High and persistent external imbalances represent a particular challenge for the economy. The current account deficit widened from 10.5% in 2009 to 14.5% of GDP in 2011 . Trade deficits have stayed above 40% of GDP and have even expanded lately. They are only partially financed by surpluses in the trade in services and in the income account. Current transfers, both to the government and the private sector, have declined but still remain significant and finance about half of the deficit in the trade in goods. Kosovo is a recipient of large remittances inflows, which are mostly channelled to finance consumption. Capital inflows have been dominated by foreign direct investments, averaging 7.7% of GDP since 2009. However, most investments have gone into the non-tradable sectors – in particular financial intermediation, construction and real estate, re-enforcing the existing structure of the economy. Kosovo's total external indebtedness has remained stable at around 30% of GDP in the last three years. Most of the debt is private, long term and linked to foreign direct investments. The Central Bank of Kosovo has recently published the international investment position (IIP), which measures the difference in external financial assets and liabilities, showing a solid 2.3% of GDP.

Table 9.1:
Kosovo - Main economic trends

		2007	2008	2009	2010	2011	2012 H1
Gross domestic product	Ann. % ch	8,3	7,2	3,5	3,2	4,5	N.A.
Private consumption	Ann. % ch	10,0	8,6	2,1	3,1	3,0	N.A.
Investment	Ann. % ch	4,1	15,3	10,7	12,3	11,3	N.A.
Unemployment	%	43,6	47,5	45,4	N.A.	N.A.	N.A.
Employment	Ann. % ch	8,1	-12,9	8,7	N.A.	N.A.	N.A.
Wages	Ann. % ch	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Current account balance	% of GDP	-10,4	-16,3	-10,5	-13,2	-14,5	-13,5
Direct investment (FDI, net)	% of GDP	12,7	8,9	7,2	7,9	8,2	6,3
CPI	Ann. % ch	4,4	9,4	-2,4	3,5	7,4	1,5
Interest rate (3 months)	% p.a.	15,25	16,61	14,11	18,24	18,13	17,69
Stock markets	Index	N.A.	N.A.	N.A.	N.A.	N.A.	N.A.
Exchange rate EUR/EUR	Value	1,00	1,00	1,00	1,00	1,00	1,00
Real eff. exchange rate	Index	-0,1	N.A.	N.A.	N.A.	N.A.	N.A.
General government balance	% of GDP	7,1	-0,1	-0,7	-2,6	-1,9	N.A.
General government debt	% of GDP	N.A.	N.A.	7,7	7,6	6,7	6,9

Sources: Thomson Reuters/Ecowin, Eurostat, Local authorities

9.1.2. Fiscal policy

In a euroised economy, the role of fiscal policy is key in preserving macroeconomic stability. In the last three years, fiscal policy has been expansionary and volatile, but the government is taking efforts to stabilise expenditures. The budget deficit increased from 0.7% in 2009 to 2.6% of GDP in 2010, before corrective actions brought it down to 1.9% in 2011. Excluding significant one off dividend receipts and budget grants, the deficit averaged just under 5% of GDP between 2009 and 2011. Primary spending grew by a nominal 45% over this period, driven mainly by strong increases in capital expenditure and spending on wages. Government priorities have been heavily oriented towards road infrastructure, leaving little resources to finance other pressing development and social needs. The construction of a highway to Albania launched in 2010 has weighed heavily on the budget, suppressing other capital expenditure and reducing fiscal space to finance other expenditure that could contribute to improving social cohesion and prospects for sustainable long-term employment and growth. By the end of 2011, total revenue increased by around 38% in comparison to 2008 as both tax and non-tax revenue increased strongly. In this period, the government drew significant dividends from the public telecom company. Moreover, tax revenue has been boosted by increased indirect taxation and improved tax collection. Most of the revenue is collected at the border, reflecting the structural dependency on imports to meet even basic consumption and investment needs.

Budget deficits have been financed mainly by withdrawals of previously accumulated government deposits, which since 2008 have fallen by around 7 percentage points to 3.5% of GDP in 2011. In 2009, Kosovo assumed obligations towards the World Bank. This accounts for most of the government debt, which stood at about 6% of GDP by the end of July 2012. This is well within the legally binding limit of 40% of GDP for government and government guaranteed debt. In 2012, the government started issuing treasury bills and declared its intention to develop further the domestic market for government securities. Overall, in view of the significant contingent and implicit liabilities, especially in the energy sector, and the numerous expenditure priorities, future government indebtedness needs to be carefully managed and monitored.

9.2. PRICE AND TRADE LIBERALISATION

Kosovo is not a member of the World Trade Organisation (WTO) and, consequently, has not had to undergo the deep reform and trade liberalisation which membership in this organisation implies. Kosovo is a member of the CEFTA and as such a signatory to the agreement eliminating barriers to trade between its members and harmonising provisions on modern trade policy issues such as competition rules and State aid.

The price setting mechanism in Kosovo is mostly free, with independent regulatory bodies regulating the prices of electricity, district heating, water, solid waste, postal services and some telecommunication services. Current governance arrangements as regards publicly-owned enterprises ensure that government does not directly interfere in the price setting mechanism of their services.

9.3. PRIVATISATION, PRIVATE SECTOR DEVELOPMENT AND FINANCIAL REFORM

9.3.1. Privatisation and private sector development

The privatisation of socially-owned enterprises begun in 2002. The Privatisation Agency of Kosovo has privatised (fully or partially) 306 socially owned enterprises. The Agency has accumulated significant proceeds in the process, which have been ring fenced to satisfy creditors and workers claims. In 2011, a new legislative framework was adopted that is expected to speed up the liquidation process. However, the privatisation of some large socially-owned enterprises still needs to be addressed.

A number of large publicly-owned enterprises in key sectors have been tendered for privatisation. In addition, the government has entered into or is considering long term public private partnerships (PPPs) as a way to draw in private investments and develop the infrastructure. In 2010, a 20-year contract was awarded to an international consortium to operate the Pristina airport. The tender has been completed for the Electricity Distribution and Supply Company in June 2012. The privatisation of the public telecom company is currently on going and is due to be finalised by the end of the year. Large privatisations and PPPs have the potential to attract investments and improve efficiency. They should however be managed carefully to limit government exposure to future liabilities and provide the right incentives for improved business and operational performance of the companies.

Services are the key component of Kosovo's private sector. Enterprises tend to be very small and mostly family-run. There is vigorous business creation, but most companies do not achieve significant growth. The obstacles to private sector development are numerous, ranging from a weak rule of law, corruption and unfair competition to unstable electricity supply, unskilled labour force as well as difficult and costly access to finance.

In the past year, the government has taken some initiatives to improve the business environment. The process of business registration has been simplified and facilitated, the number of required documents for exporting and importing has been reduced, and a number of licences have been removed. Kosovo has made important steps towards improving its legislative and regulatory framework but still faces a major challenge with regard to its implementation.

9.3.2. Financial sector reform

The financial sector (excluding the Central Bank) has expanded by more than 40% over the last three years, reaching around 75% of GDP in the end of 2011. The sector is dominated by eight commercial banks (76% share in total assets), followed by pension funds (17%), microfinance institutions (4%) and insurance companies (3%). Concentration is high and the three biggest banks hold 73% of the assets. Close to 90% of all bank assets are managed by banks under foreign ownership. All banks have capital adequacy ratios above the required minimum of 12% and the average ratio for the whole system is around 18%. Banks' profitability and liquidity indicators are also high. Non-performing loans remain at manageable levels, although they have slightly increased to about 7% in the first half of 2012. Financial intermediation has steadily deepened and total deposits and lending has increased on average by double digit rates over the last three years. The system relies on domestic sources of finance. Deposit levels have been kept constantly above lending, providing an additional source of stability in a relatively risk averse system.

In April, a new law on banks, microfinance institutions and non-bank financial institutions was adopted. It enhances governance standards, introduces tighter restrictions for lending to bank-related parties and allows consolidated supervision for banking groups. Additionally, the law strengthens the existing framework for bank resolutions. This includes establishing a framework that authorises the Central Bank to take control of a bank before it reaches insolvency. It also provides a clear legal framework for oversight of microfinance and non-bank financial institutions.

9.4. CONCLUSIONS

Kosovo has implemented the initial essential reforms towards establishing a fully functioning market economy. This is sufficient to establish contractual relations with countries from the Western Balkans, as stated in the Council Conclusions of April 1997. At the same time, Kosovo's economy faces many important challenges. Unemployment is very high and the private sector remains weak. Informalities are widespread and the rule of law needs to be enhanced to improve the business environment and support private sector development. Significant further efforts are needed to better target economic policies, address fiscal consolidation, job creation and competitiveness issues, and promote private investments to achieve more sustainable and inclusive growth.

ANNEX 1
Abbreviations

BiH	Bosnia and Herzegovina
CBBH	Central Bank of Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
EFPs	Economic and Fiscal Programmes
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
fYRoM	The former Yugoslav Republic of Macedonia
GDP	Gross domestic product
HRK	Croatian Kuna
ILO	International Labour Organization
IMF	International Monetary Fund
MTEF	Medium-Term Expenditure Framework
PEPs	Pre-Accession Economic Programmes
PRGF	Poverty Reduction and Growth Facility
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SMEs	Small and Medium sized Enterprises
SOEs	Socially owned enterprises
UNSCR 1244	United Nations Security Council Resolution 1244

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