Progress towards meeting the economic criteria for accession: the assessments of the 2007 Progress Reports

Directorate-General for Economic and Financial affairs
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PROGRESS TOWARDS MEETING

THE ECONOMIC CRITERIA FOR ACCESSION:

THE ASSESSMENTS OF THE 2007 PROGRESS REPORTS

BY

DIRECTORATE GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS
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1. **INTRODUCTION**

In this Occasional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2007 Progress Reports on progress made towards meeting the accession criteria of each candidate\(^1\) and potential\(^2\) candidate country. The European Commission adopted these Reports on 6 November 2007. 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, which 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 2007 Progress Reports\(^3\).

*The methodology of the Progress Reports*

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

The criteria are:

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

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

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

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

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1 Croatia, the former Yugoslav Republic of Macedonia and Turkey
2 Albania, Bosnia and Herzegovina, Montenegro, Serbia and Kosovo (UN1244)
Regarding the economic criteria, the Commission has examined progress achieved during each year on the basis of a number of subcriteria applied since 1997.

According to these

the existence of a functioning market economy requires that:

- equilibrium between demand and supply is established by the free interplay of market forces; prices, as well as trade, are liberalised;
- significant barriers to market entry (establishment of new firms) and exit (bankruptcies) are absent;
- the legal system, including the regulation of property rights, is in place; laws and contracts can be enforced;
- macroeconomic stability has been achieved including adequate price stability and sustainable public finances and external accounts;
- broad consensus exists about the essentials of economic policy;
- the financial sector is sufficiently well developed to channel savings towards productive investment.

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

- the existence of a functioning market economy, with a sufficient degree of macroeconomic stability for economic agents to make decisions in a climate of stability and predictability;
- a sufficient amount, at appropriate costs, of human and physical capital, including infrastructure, education and research, and future developments in this field;
- the extent to which government policy and legislation influence competitiveness through trade policy, competition policy, state aids, support for SMEs, etc.;
- the degree and the pace of trade integration a country achieves with the Union before enlargement. This applies both to the volume and the nature of goods already traded with Member States;
- the proportion of small firms, partly because small firms tend to benefit more from improved market access, and partly because a dominance of large firms could indicate a greater reluctance to adjust.

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

It is important to note that these conditions do not serve as a simple checklist. First, the interplay and interaction of all conditions, and their mutually reinforcing effects on the economy, are pertinent. Second, there is an important time dimension involved. Meeting the economic criteria requires deep and lasting structural reforms that take time to be accomplished. The issue of track record becomes then very relevant. In this context, the concept of track record means the irreversible, sustained and verifiable implementation of reforms and policies for a long enough period to allow for a permanent change in the expectations and behaviour of economic agents and for judging that achievements will be lasting.
The assessments in the Progress Reports are backward-looking over the reporting period of one year\(^4\), they refrain from attempting to forecast possible future developments. Furthermore, the reports do not attempt to provide explicit policy advice, but rather track recent developments on a factual basis.

The conclusions of the assessments in the economic chapters are provided at the end of each country section in this publication.\(^5\) An important difference in the nature of the conclusions for candidate countries on the one hand and potential candidate countries on the other hand should be noted. Namely, in the case of candidate countries the conclusions summarise the state of compliance with the Copenhagen economic criteria (= level of compliance), while in the case of the potential candidate countries they rather refer to the progress achieved towards compliance. The reason for this is that for candidate countries the Commission has already assessed the level of compliance for the first time in its opinions on the countries' EU membership applications. This exercise has not yet been undertaken for potential candidate countries, and therefore the assessment and the conclusions can naturally only refer to further progress achieved rather than to level of compliance. The latter will only be assessed at a later stage, in a Commission opinion once requested by the Council, and following a potential candidate countries' application for EU membership.

\(^4\) For a more short-term overview of recent economic developments, see for example the "Candidate and Pre-Accession Countries' Economies Quarterly" (http://ec.europa.eu/economy_finance/indicators/ceeq_en.htm)

2. CROATIA

2.1. Introduction

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

2.2. The existence of a functioning market economy

Economic policy essentials

The country participates fully in the EU Pre-Accession Fiscal Surveillance procedure. The third Pre-accession Economic Programme 2007-2009, submitted in December 2006, presents a coherent fiscal framework and an ambitious agenda for structural reforms. If fully implemented, it would further improve the functioning of markets and support sustainable growth and real convergence. The programme with the International Monetary Fund (IMF) was successfully completed in November 2006 and the authorities did not request a successor arrangement. Cooperation with the World Bank remained an important anchor for structural reforms. However, economic policy coordination between various parts of the government was sometimes insufficient. The economic rationale of reforms has not always been communicated effectively to the general public. At times, the limited impact of existing economic expertise on government decision making reduced the scope and pace of structural reform, in particular prior to the 2007 general elections. Overall, consensus on the fundamentals of a market economy has been maintained, but the government has not taken full advantage of its economic expertise.

Macroeconomic stability

In 2006, real GDP growth accelerated to 4.8% year on year, up from 4.3% in 2005. Growth continued to be largely driven by strong domestic demand. Stronger private investment contributed to an acceleration of total real investment growth to 10.9%, up from 4.8% in 2005. Private consumption grew by around 3.5% in real terms. The growth of exports of goods and services accelerated to 6.9%, but was lower than the increase in imports (7.3%). Economic growth remained robust in 2007. Real GDP growth accelerated further to 6.8% in the first half and industrial production went up by 7% year on year in the first eight months of 2007. Overall, the economic performance remained strong, with real growth rates above potential growth.

Domestic demand and growth led to stronger imports and a slight widening of the trade deficit to 24.4% of GDP. As in previous years, this deficit was only partly offset by the surplus in the trade in services, mainly tourism, which was down slightly at 16.6% of GDP. Moreover, the balance of net factor income fell owing to strong increases in dividend and interest payments as well as higher retained earnings. Also, transfer payments to Croatia from abroad declined as a percentage of GDP. As a result, the current account deficit widened significantly from 6.4% of GDP in 2005 to 7.8% in 2006 and in the 12 months to June 2007, with no major changes in its composition. External deficits have continued to widen.
Net inflows of foreign direct investment (FDI) almost doubled as a percentage of GDP to 7.4% in 2006 and to 9.2% of GDP in the 12 months to June 2007. Thus, net FDI flows largely financed and recently even exceeded the current account deficit. Due to strong and persistent capital inflows, official foreign reserves increased to around € 9.2 billion, or by 6.5% year on year in July 2007. Gross external debt continued to grow, although at a slower pace, to EUR 30.4 billion in August 2007 or to around 83 of the GDP expected for 2007. At end-2006, the external debt-to-GDP ratio stood at 84.7%, up from 82.6% in 2005. In sum, capital inflows remained strong, and external debt continued to rise, albeit at a slower pace.

Employment growth accelerated markedly to 3.4% in 2006, up from 0.8% in 2005. Provisional data for 2007 point to a slowdown in employment growth, but subsequent upward revisions are likely. The officially registered unemployment rate showed a marked decline to 13.8% in August 2007, the lowest rate since end-1995, compared to 15.7% in August 2006. Labour force survey data recorded a fall in the unemployment rate to 10.5% in the second half of 2006, from 12.3% a year ago. It declined for all age groups, but still remained high for the young population (29%). The long-term unemployment rate decreased to 5.6% (2005: 6.7%). Overall, the labour market performance improved, but the relatively high unemployment rate and limited job turnover remained a concern.

A sound monetary policy framework of a “managed float” with the primary objective of maintaining price stability remained in place. The Central Bank continued to target broad stability in the kuna/ euro exchange rate without any commitment to a particular exchange rate level or band. A number of factors contributed to significant foreign exchange inflows and a persistently strong demand for kuna. Among those, continued foreign borrowing by banks and enterprises, a government bond issue, the take-over of a domestic company by a foreign investor and increases of capital in some foreign-owned banks played a major role. In an effort to alleviate persistent appreciation pressures, the central bank intervened several times on the foreign exchange market during 2006 as well as in July 2007 to purchase a net total of around EUR 1.3 billion from commercial banks. In 2006, the kuna appreciated by 0.5% against the euro in nominal terms, followed by a slight year-on-year depreciation of
0.8% in August 2007. Overall, exchange rate stabilisation has been successful and remains a key policy priority.

The central bank re-instated, and subsequently tightened, direct administrative credit controls in order to discourage foreign borrowing by commercial banks and to contain domestic credit growth. These took effect in early 2007, in addition to already adopted regulations which had been only partially effective in containing credit growth. Annual growth of broad money accelerated from 16.6% in September 2006 to 19% in August 2007. In the same period, annual domestic credit growth slowed somewhat from 22.4% to 18.7%. Recently, bank credit to households grew stronger than credit to enterprises, but the corporate sector continued to revert to direct external and non-bank sources of financing. Overall, in an attempt to contain credit growth, monetary policy also continued to rely on administrative measures, including additional credit control.

Average annual consumer price inflation declined slightly from to 3.3% in 2005 to 3.2% in 2006. Higher prices for agricultural goods led to an increase of year-on-year consumer price inflation from 2% in December 2006 to 2.6% in August 2007. Annual average inflation declined further to 2% in the first eight months of 2007. Lower price rises for energy, a stable exchange rate and increased competition in retail trade have contributed to price stability. Core inflation, which excludes agricultural products, energy and other administrative prices, dropped from 3.1% in 2005 to 2.5% in 2006 and slightly increased to 2.6% in annual average terms in the first eight months of 2007. Overall, price stability has been maintained.

In line with policy targets, the budget deficit6 in 2006 was markedly reduced to 2.2% of GDP (3.9% in 2005). Total revenues rose 9% on the back of particularly strong growth in direct taxes, VAT and social contributions. Current spending (government consumption, subsidies and social transfers) rose by 7.1%, but its share of GDP fell by 1.4 percentage points to 44.8% of GDP. Capital spending as a share of GDP declined by 0.4 percentage points, albeit from the relatively high level of 4% of GDP in 2005. Strong economic performance contributed to favourable fiscal developments in the first half of 2007. Revenue growth exceeded expectations and accelerated to 13.1% year-on-year, with total spending growing by 6.8%7. A supplementary budget for 2007 with major revisions was adopted in July. It includes additional revenues of 2% of GDP, part of which is to be used to settle financial obligations, particularly in the health sector. The revision also allowed for an increase in current spending, including for education, subsidies, and social benefits. The deficit was reduced only slightly, to 1.6% of GDP, from the 1.8% planned in the original budget. There was a marked slowdown in the growth of general government debt and the debt ratio fell to 40.7% at the end of 2006 (from 43.7% in 2005). Overall, fiscal consolidation continued as planned, while recent levels of revenue above expectations have led to an expansion of current spending.

The rationalisation of public spending remained a key public finance objective. The government adopted a social welfare reform to streamline numerous benefits and achieve a better targeting of social assistance through the wider application of means-testing. However, a new population policy adopted in late 2006 partly contradicts these objectives. Initial reforms to the financing of health care, which were adopted in mid-2006, have so far not been complemented by more ambitious steps to fully address the sector's financial difficulties. Recent increases in pensions and the lowering of the early retirement "discount"

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6 Budget numbers in this paragraph refer to the consolidated general government deficit as defined under ESA 95.

7 Growth rates refer to year on year growth in the first quarter.
partly reversed earlier important parametric reforms of which aimed at improving the financial sustainability of the "pay as you go" system. Important quasi-fiscal operations added uncertainties to the overall fiscal stance. These included debt repayments to pensioners, debt write-offs in the context of privatisations, state guarantees for restructuring companies and the operations of the State Development Bank. Public finances continued to be faced with significant risks, and ensuring lasting fiscal consolidation remains an important challenge.

Progress has been made in enhancing analytical capacity for setting up medium-term fiscal frameworks. Budget planning capacity and procedures have improved, with wider use being made of fiscal impact assessments. The link between strategic planning and the budget process remained generally weak. The reform of the treasury system continued, but a number of extra-budgetary funds still remain outside the single treasury account, undermining effective budget control. Although efforts have been made to reconcile fiscal statistics with ESA 95, local governments were still only partially included in fiscal reporting. Procedures for recording public debt have improved and become more transparent. However debt management continues to be beset by considerable operational shortcomings, weak segregation of duties and a significant key person risk. Overall, there has been a further strengthening of analytical and institutional capacity in some important areas of the Ministry of Finance.

Stabilisation of the high and rising external debt has remained an important policy target. The general orientation of macroeconomic policies has, on the whole, been appropriate to contain potential external vulnerabilities. Given the limited scope for monetary policy discretion under the circumstances of currency substitution, fiscal policy continued to play an important role in containing the savings-investment balances in the economy. So far the authorities have not taken advantage of the generally benign economic environment to pursue a more ambitious path of fiscal consolidation. However, there may be a strong argument for such consolidation as a way to reduce external risks, increase the flexibility of fiscal policy and make more room for greater private sector initiative. In sum, the macroeconomic policy mix has generally been appropriate, but there is still scope for a more ambitious fiscal policy.

Interplay of market forces

The private sector's share of output has continued to rise, to an estimated 70% of GDP. The private sector's share of total employment grew from 67.8% in 2005 to 68.8% in 2006. At the same time, state intervention and ownership remained significant in important industrial sectors, such as in the shipbuilding industry.

The State's 17% shareholding in the national oil company INA was successfully sold in late 2006. Recently, the government decided to sell a further 7% of shares to the company's former and current employees at a reduced price. More than half of the remaining government shares in the telecommunication company (32.5%) were sold off through public tendering at the end of September 2007. Up to September 2007, the State Privatisation Fund had sold a total of around 100 companies; however, the remaining portfolio still comprised around 880 companies, and the State had a majority holding in 100 of them. A major corruption investigation led to the dismissal of the Fund's management in June 2007 which affected the pace of privatisation. Overall, the privatisation process has been uneven and sometimes hampered by legal problems, institutional weaknesses and unrealistic conditions of sale.
**Market entry and exit**

Company registration procedures have been further simplified through the gradual establishment of additional one-stop shops throughout the country. The average time and number of procedures needed to set up a business, as well as average registration costs, have been reduced. New company registrations grew by 7% year on year in the first half of 2007 and the stock of active businesses increased by 7.4% year-on-year in June. Following earlier changes to the law, business exits benefited from more efficient and simplified bankruptcy procedures. Preparatory steps were taken to reduce the burden of legislation in the context of the "Regulatory Guillotine" project, however its implementation has not yet started. Procedures for obtaining licences and building permits remain cumbersome. Overall, there has been some progress in removing bureaucratic obstacles to market entry and exit, but significant administrative inefficiencies remain.

**Legal system**

Some progress was made in reducing the backlog of cases before Croatian courts. However, the backlog is still a large one and the judicial system has continued to suffer from slow and inefficient court proceedings, poor case management and low professional capacity. These circumstances may discourage economic actors from taking cases to court and undermine effective enforcement of creditor and property rights.

**Financial sector development**

The banking sector represented slightly more than three quarters of total financial sector assets in mid-2007. Some 96% of banks are privately owned and the share of foreign ownership remained high at 91%. In 2006, the number of banks fell by one to 33, which is still high in relation to the overall market size. The degree of market concentration remained moderate and generally has not been an impediment to market competition. The five largest banks together accounted for a market share of around 72% at the end of 2006, slightly down on 2005. The spread between average kuna lending and deposit rates fell by 1.2 percentage points during 2006 and an additional 0.4 points in the first seven months of 2007. Domestic private credit rose to 71.5% of GDP in 2006, up from 62.9% in 2005. The share of non-performing assets declined further to 3.2% in 2006 (from 4% in 2005), although this indicator may understate portfolio risks during periods of strong asset growth. The banking system still has to contend with foreign-exchange induced credit risks arising from un-hedged balances in the non-financial sector. Overall, the largely privately-owned banking sector remained generally sound, amid a rapid credit expansion.

The share of non-banking financial sector assets in total financial sector assets increased from 21.4% at end-2005 to 23.6% at end-2006 and above 26 % by mid-2007. This was primarily due to strong asset growth of investment funds, leasing companies and mandatory pension funds. The shares of other market segments (voluntary pension funds, saving cooperatives, housing savings banks, insurance) have not changed significantly. There has been a further increase in bond market capitalisation, which rose to around 17% of GDP by end-2006 (2005: 14.3%), owing to a large number of new emissions, primarily by the corporate sector. Stock market capitalisation rose markedly - to around 80% of GDP - at the end of 2006, but this was more a reflection of the big increases in share prices rather than of an expansion of the stock market. In general, equity and bond markets remained relatively shallow.

A number of measures have been taken to strengthen the supervision of the financial sector, in particular with a view to closer monitoring of currency-induced credit risk. Reserves for
the fastest growing banks were also increased. Prudential regulation led to a stronger recapitalisation of banks, which has been conducive to financial sector stability in general.

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

Existence of a functioning market economy

Macroeconomic stability has been maintained and has allowed economic agents to make decisions in a climate of stability and predictability, thus supporting the functioning of market mechanisms. However, external imbalances and fiscal risks bring vulnerabilities, and private sector development has been rather slow.

Human and physical capital

Reforms in the education sector continued. Further steps were taken to improve the quality of education at all levels. Attempts were made to enhance the scope and quality of adult education, but participation rates in life long learning remained low, at 2.5% in 2006 (2005: 2.3%). The education sector generally still suffers from out-dated curricula and poor equipment. Students as a percentage of the population stayed low, at 3%, and only a small proportion of students are graduating in science and research. The government adopted an annual programme for employment promotion in 2007, which plans to continue the active labour market policy measures introduced in 2006. The programme includes training and employment subsidies for young people without work experience, the long-term unemployed, older persons and vulnerable groups. However, although there was a slight increase in employment and participation rates, the levels remained relatively low - at 56.6% and 63.5% respectively in the second half of 2006. Overall, the labour market continued to suffer from a mismatch between supply and demand.

Investments - driven in particular by stronger private investment - continued their strong growth in 2006 and early 2007, and the fixed investment ratio reached 30% of GDP in 2006 (2005: 28.6%). Total spending on research and development remained relatively high, at around 1% of GDP. Public investment in transport remained strong. It resulted in a further expansion of the extensive motorway network by some 100 km to over 900 km. However, the road network continued to suffer from a significant maintenance backlog. The core main lines of the rail network are sufficiently well maintained to allow a competitive freight transport business.

Net inflow of foreign direct investment (FDI) almost doubled as a percentage of GDP to 7.4% in 2006; this growth was mostly due to direct equity investments. The takeover of a pharmaceutical company, recapitalisation of some foreign-owned banks and the acquisition of two domestic banks contributed significantly to this. The financial sector accounts for the largest share of cumulative FDI inflows (31.1%), followed by manufacturing (27.2%), then post and telecommunications (13.5%). There has still been little greenfield investment, and private investments in the processing and manufacturing industry have remained relatively low, limiting technological change and export potential. To conclude, strong levels of investment continued to be largely concentrated in transport infrastructure and the services sector.
Progress was made in the restructuring and privatisation of the two loss-making, state-owned steel mills and the aluminium company (TLM). Following repeated tendering procedures, the two steel mills were sold and an investor for TLM was chosen. In the area of shipbuilding, draft restructuring plans for each shipyard were submitted to the European Commission, but these – together with a national restructuring strategy for shipbuilding – have still to be finalised by the government. The privatisation of the first shipyard has been further delayed. The government's commitment to a comprehensive restructuring of the sector to ensure its long-term economic viability remained rather low. The remaining agricultural conglomerate subject to a tendering process, but has not yet been sold. Overall, progress with the restructuring and privatisation of large loss-making state-owned companies has been rather slow (See also Chapter 20-Enterprise and industrial policy and Chapter 8- Competition).

The restructuring of the large railway carrier by separating its subsidiaries continued, creating scope for further staff reductions and efficiency gains. However, the railway sector continued to consume high levels of budget support, amounting to around 1.3% of GDP in 2006. Relatively low productivity and high unit labour costs are undermining its long-term viability, in particular once the network is opened up to competition. Five railway subsidiaries have been tendered for privatisation, but have not yet been sold. The liberalisation of the telecommunication industry continued, but network access needs to be further improved. Croatian Telecom continued to be the dominant supplier. New fixed line operators entered the market, raising their market share from 4% to a still modest - 13%. Stronger competition in the mobile phone sector led to significantly lower prices. The restructuring and liberalisation of the energy sector is advancing gradually. Preparations for the privatisation of the large electricity company have made no progress. Overall, the reform of network industries made headway, but the railway sector needs much deeper restructuring to ensure its long-term viability and competitiveness.

The already large service sector maintained its share of total output at around 61%. Agriculture's share of output declined further to 7.4% in 2006 (from 7.6% in 2005). The construction sector increased to 7.1% (6.8%), while industry's share dropped to 24.5% (from 24.8%). Agriculture's share of employment showed a marked fall to 14% (2005: 17%), while industry rose slightly to 29% (2005: 28%) and the services sector posted a more pronounced rise to 57% (2005: 55%). Given the already large service sector, there were only marginal shifts in the sector structure of the economy.

The small and medium-sized enterprise (SME) sector continued to grow in 2006, representing 40% of the corporate sector's total assets, 98.5% of the total number of firms and 55% of total employment. SMEs generated more than 44% of GDP and almost one quarter of total exports. SMEs continued to benefit from support initiatives and subsidy schemes at various government levels. However, the sector continued to suffer from a cumbersome regulatory framework and inefficiencies in public administration. Access to longer-term financing remained difficult, particularly for newly established businesses. Overall, the SME sector has gained in importance, despite the remaining administrative obstacles.

State influence on competitiveness

There has been further progress in strengthening the role of the Competition Agency in monitoring and controlling state aid. Communication and cooperation with potential state aid providers, including national and regional administrations, has improved. However, the relatively low levels of staffing and budgetary resources allocated to the Agency, somewhat
hindered a more effective state aid control. Total state aid reportedly increased, from around 2.3% of GDP in 2005 to 3.4% in 2006. In 2007, restructuring aid to loss-making enterprises increased significantly, which may undermine the implementation of the government's subsidy reduction plan. The latter provides for the gradual reduction of subsidies as a share of GDP. A large share of subsidies continued to go to specific sectors, such as the railways and the shipbuilding, steel and aluminium industries. Horizontal aid accounts for only a small share of state aid. Overall, state intervention in the enterprise sector remained substantial.

**Economic integration with the EU**

Croatia is an open economy with total trade in goods and services representing more than 100% of GDP. In 2006, there was a further increase in both imports and exports as a percentage of GDP. Apart from the export of transport equipment (mainly ships), tourism continued to be the biggest source of export revenue, representing almost 18% of GDP in 2006. In 2006, the EU has continued to be the most important trading partner with a slightly higher share of around 63.5% in Croatian exports (from 62% in 2005) and an unchanged share of 65% in imports. At the same time, Croatia has expanded its trade with neighbouring countries as well as with Russia and China. Around 95% of FDI inflows originate from EU Member States. Overall, integration with the EU in the areas of trade and investment is very high, and trade with neighbouring countries has grown.

The 2.9% growth in real wages was less than that of average labour productivity (3.9%), with the result that real unit labour costs fell by 1%. The nominal effective exchange rate of the kuna appreciated by 3.4% in 2006, largely due to strong upward movement of the kuna against the US dollar. In real effective terms, the Kuna appreciated at a lower rate (2%), as producer prices rose faster abroad than on the domestic market. Overall, standard indicators suggest no significant changes in export price competitiveness.

Average per-capita income in 2006 rose to 50% of the EU-27 average from 47% in 2005.

### 2.4. Conclusions

Croatia’s economy registered strong and accelerated growth. Macroeconomic stability, including low inflation, was maintained. However, external imbalances may affect macroeconomic stability. Fiscal consolidation continued and needs to be further pursued. Structural reforms as well as privatisation moved forward slowly. The overall business environment improved but inefficiencies in public administration and the judiciary continued to hamper private sector development.

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

Broad political consensus on the fundamentals of a market economy has been maintained. Stability-oriented macroeconomic policies have contributed to low inflation, exchange rate stability and a significant reduction of the general government deficit. Economic performance remained strong and private investment picked up further. Employment rose

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8 As measured on the basis of producer prices.
9 In purchasing power standards.
and unemployment, though still high, declined. The business environment improved and some important privatisation deals were prepared or concluded. The government's capacity to design medium-term economic policy frameworks was further strengthened. New prudential regulations led to a stronger recapitalisation of banks, conducive to financial sector stability. Further progress was made in enhancing competition in the telecommunication sector. Reforms of the loss-making railway system continued. Croatia's economy is well integrated with the EU.

However, economic policy coordination remained weak. Rising external imbalances imply potential risks to macroeconomic stability and the need for stronger fiscal consolidation. The benign economic environment and strong revenues were not fully used to reduce the budget deficits, but led to an expansion of spending instead. Subsidies to loss-making enterprises and a high level of current spending continued to slow down structural change and to put a strain on public finances. Progress on the restructuring of the enterprise sector was uneven and state intervention remained significant. Private sector initiative was hampered by inefficiencies in public administration and the judiciary, partly undermining market entry and exit procedures and the enforcement of property and creditor rights. Labour mobility remained limited. In order to improve prospects for sustained growth and real convergence, Croatia needs to reinforce and deepen structural reforms.
3. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

3.1. Introduction

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

3.2. The existence of a functioning market economy

Economic policy essentials

The country is fully participating in the EU's pre-accession fiscal surveillance. It presented its first Pre-accession Economic Programme (PEP) in December 2006 and submitted its second fiscal notification in April 2007. All the political parties concerned agree on the objective of establishing a market-based economy. The new government presented its economic programme in autumn 2006, emphasising the goals of fostering economic growth and addressing unemployment. Programme cooperation with the International Monetary Fund (IMF) and World Bank is on track, with positive assessments from both institutions concerning the programme commitments. A broad political consensus has been maintained on the fundamentals of economic policy, although political disputes have occasionally slowed down the reform process.

Macroeconomic stability

Real GDP growth accelerated from 3.5% in the second half of 2006 to 5.5% in the first half of 2007. The main factors were strong growth of commodity exports and increased private consumption. Industrial production also increased, by some 2.5% in the first eight months of 2007, compared with 2.8% for the same period the year before. Overall, stability has been maintained.

The current account deficit declined further to 0.4% of GDP in 2006, compared with 1.4% in 2005. During the first half of 2007, the current account even posted a small surplus, benefiting from strong export growth and private transfers. The share of exports in GDP increased from 36% of GDP in 2006 to 38% in 2007. Net private transfers remained high, on around 19% of GDP in 2006 and a similar level in the first half of 2007. Net inflows of foreign direct investment (FDI) returned to some 1¼% of GDP in the second half of 2006 and rose to 2¼% of GDP in the first half of 2007, after privatisation of an electricity distribution company had pushed them up to 5.6% in 2006. Overall, external imbalances have again narrowed substantially, although FDI inflows are still low.

The official reserve assets of the National Bank of the Republic of Macedonia (NBRM) stood at €1.5 billion mid-September 2007, which is equivalent to about five months of imports of goods and services. The main reasons for the further increase in reserves were the private transfers and other foreign exchange inflows via the cash exchange offices. Gross external debt had fallen to about 33% of GDP by end-August 2007, reflecting early repayments to Paris Club creditors, the IMF, the World Bank and the EIB. This reduced the costs of servicing the public debt by about 10% (or 0.1% of GDP).
The former Yugoslav Republic of Macedonia - Main economic trends

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
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<tbody>
<tr>
<td>Gross domestic product</td>
<td>0.8</td>
<td>2.9</td>
<td>2.9</td>
<td>3.8</td>
<td>3.0</td>
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<tr>
<td>Private consumption</td>
<td>12.5</td>
<td>-1.5</td>
<td>6.2</td>
<td>1.9f</td>
<td>3.0f</td>
<td>5.0</td>
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<tr>
<td>Gross fixed capital formation</td>
<td>17.6</td>
<td>1.1</td>
<td>10.9</td>
<td>3.0f</td>
<td>4.0f</td>
<td>11.6</td>
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<td>Unemployment</td>
<td>%</td>
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<td>37.2</td>
<td>37.3</td>
<td>36.0</td>
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<td>Employment</td>
<td>%</td>
<td>-6.3</td>
<td>-2.9</td>
<td>-4.1</td>
<td>4.3</td>
<td>4.6</td>
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<tr>
<td>Wages</td>
<td>%</td>
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<td>4.8</td>
<td>4.0</td>
<td>2.7</td>
<td>8.0</td>
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<tr>
<td>Current account balance</td>
<td>%</td>
<td>-9.5</td>
<td>-3.3</td>
<td>-7.7</td>
<td>-1.3</td>
<td>-0.4</td>
</tr>
<tr>
<td>Direct investment (FDI, net)</td>
<td>%</td>
<td>2.1</td>
<td>2.0</td>
<td>2.9</td>
<td>1.6</td>
<td>5.8</td>
</tr>
<tr>
<td>CPI</td>
<td>%</td>
<td>2.3</td>
<td>1.1</td>
<td>-0.4</td>
<td>0.5</td>
<td>3.2</td>
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<tr>
<td>Interest rate (3 months)</td>
<td>%</td>
<td>8.49</td>
<td>9.95</td>
<td>6.40</td>
<td>5.69</td>
<td></td>
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<td>Bond yield</td>
<td>%</td>
<td></td>
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<td>911</td>
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<td>Exchange rate MKD/EUR</td>
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<td>61.32</td>
<td>61.30</td>
<td>61.19</td>
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<td>Nominal eff. exchange rate</td>
<td>Index</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>General government balance</td>
<td>%</td>
<td>-5.6</td>
<td>-1.1</td>
<td>0.0</td>
<td>0.3</td>
<td>-0.6</td>
</tr>
<tr>
<td>General government debt</td>
<td>%</td>
<td>48.7</td>
<td>45.0</td>
<td>43.8</td>
<td>48.5</td>
<td>41.5</td>
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</tbody>
</table>

Sources: Eurostat, Reuters/Ecowin, National sources, * EC Autumn 2007 forecast

Unemployment is very high at some 36% of the labour force and declined only by about a ½ percentage point over the last year (to 35.8% in the first quarter of 2007). Employment, however, increased by some 3% during the last year, raising the employment rate from some 35% in mid-2006 to about 36% in mid-2007. The modernised labour code, which has been in force since 2005, has probably had a positive impact on job creation. However, a considerable part of the unemployment is structural, as confirmed by the weak link between economic growth and the level of employment. Unemployment among the young is still very high and the duration of unemployment in this age group is long. Because of the large informal sector, unemployment could be overestimated. Overall, employment is continuing to grow. However, progress with reducing unemployment has remained limited.

The NBRM has managed to keep the exchange rate of the denar stable at 61.2 denar/ euro and sustained a de facto peg. The NBRM has slightly reduced policy interest rates. Rates for Central Bank bills declined from 5.5% in mid-2006 to 5.1% by August 2007. Private-sector rates have continued to decline: weighted lending rates of commercial banks in domestic currency were cut from 11.1% at the end of August 2006 to 10.1% in August 2007. Credit growth to the private sector continued to be high, at some 34% (year on year) during the first eight months of 2007. The volume of broad money (M410) rose by 33% year on year during the first eight months of 2007. Overall, exchange rate and monetary policy have remained sound. This has helped to maintain confidence in the stability of the financial system.

Consumer price inflation slowed down to 1.4% during the first nine months of 2007, compared with 3.3% for the same period in 2006. Consequently, inflation returned to the low levels of previous years after special factors, such as the increase in excise taxes and higher energy prices, had pushed inflation up to 3.2% in 2006. Overall, inflation remains under control.

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10 The money aggregate M4 includes all notes and coins in circulation and deposits on bank accounts.
Fiscal policy became more expansionary towards the end of 2006, when the new government adopted a supplementary budget with additional spending of some 2% of GDP. Substantial budget surpluses in the first half of 2006 kept the annual public-sector deficit within the target for 2006 of 0.6% of GDP. After a fiscal surplus of 0.2% of GDP in 2005, this performance represented a fiscal impulse of 0.8% of GDP. The budget proposed for 2007 envisages a significant reduction in the fiscal burden while containing expenditure growth. In order to stimulate investment and economic growth, the authorities have introduced a "flat tax" on personal income and profits, reducing the rates for these two taxes to 12% from 1 January 2007. The same law provides for a further reduction to 10% on 1 January 2008. On the expenditure side, the government plans to reduce public spending by 2 percentage points of GDP by 2010. In all, an increase in the deficit to about 1% of GDP is planned for 2007. However, data for the first eight months point to a better than expected performance of revenue and expenditure. Overall, fiscal policy has become slightly more expansionary, but remains sound. However, the regular underperformance in implementing public investment plans points to serious administrative weakness in this sector.

Fiscal decentralisation entered its second phase in July 2007. Measures are being taken to settle the issue of municipal debt arrears, with the overall level reduced from about 1% of GDP in mid-2006 to about 0.5% by mid-2007. However, in some cases the new powers pose significant challenges to the municipalities and require close monitoring by the central authorities. At the moment, expenditure by the lower levels of government accounts for about 7% of total public-sector expenditure or about 2.4% of GDP. Mainly due to early debt repayments, public debt has fallen significantly (according to GFS from 39.4% of GDP end of 2006 to about 29% by end July 2007). The authorities have continued to improve the efficiency of tax administration and to simplify the tax system. Overall, the accounts of the public sector have remained largely balanced and public administration has been further strengthened. However, the quality of the public finances is impaired by weaknesses in medium-term budget planning and priority-setting, leading to a high share of discretionary and short-term oriented spending decisions.

The country's fiscal and monetary policy has supported an acceleration of economic activity, while maintaining overall economic stability. Public finances remain close to balance. Exposure to external shocks has been reduced by increasing foreign exchange reserves and reducing external debt. Inflation has been kept under control. However, unemployment remains high. Overall, the macroeconomic policy mix has succeeded in maintaining economy stability, although high unemployment and insufficient investment remain key challenges.

**Interplay of market forces**

Privatisation has largely been completed and the share of the private sector in total output has increased further to about 80% of the value added. The value of state-owned assets accounts for some 15% of GDP, with five state utilities accounting for 13.7% of GDP. The value of state-owned assets in the other 65 companies adds up to some 1.5% of GDP. Majority state-owned companies employ some 10,000 people or about 1.3% of the labour force. During the last year, the sale of a number of the last remaining minority state shares in the banking sector, combined with the sale of company shares owned by the Health Insurance Fund, generated revenue totalling about 0.5% of GDP. In the telecommunications sector, the state has liberalised access to the market, which has already resulted in a

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11 The data are still based on the IMF accounting standard GFS and are not yet fully in line with the ESA 95 European accounting standard.
reduction in communication tariffs. Liberalisation of the air transport market has also started. Overall, the free interplay of market forces has further increased.

**Market entry and exit**

The government has continued to lower entry barriers and to speed up registration and exit procedures. Major developments in this respect were amendments to the laws on the one-stop shop, the trade registry and the registry of other legal entities, which resulted in a further simplification and facilitation of company registration procedures. For example, the time taken for company registration was further reduced from 5 days to 3 days, and registration costs are now less than € 100. During the first nine months of 2007, about 7,500 new companies were registered, compared with 6,700 in the same period of 2006. Companies which registered during the last year make up nearly 15% of the total stock of companies. In June, the authorities started to implement the "regulatory guillotine", involving a significant reduction in redundant legislation, introduction of the "silence is consent" principle, lowering of fees in a number of areas and simplification and shortening of a number of procedures. The legislation on bankruptcy procedures was amended with a view to improving the procedures and accelerating implementation. During the first nine months of 2007, 4,100 companies were taken off the register, while nearly 2,100 new bankruptcy procedures were registered. The backlog in bankruptcy cases has been reduced. Overall, barriers to market entry and exit have been further reduced and key implementing legislation has been adopted.

**Legal system**

The necessary legal system is largely in place. Significant progress has been made on accelerating registration of property rights. By August 2007, the coverage of the real estate cadastre had increased to 68% of the territory of the country, compared with 47% in autumn 2006. The registration procedure was amended in order to facilitate registration of foreign investors. Allowing commercial cases to be enforced by licensed enforcement agents has led to significantly faster enforcement of court decisions. However, legal procedures in general are still slow, which impedes proper law enforcement. Therefore, progress on settling ownership disputes has been limited. Overall, progress has been made on further accelerating market entry, clarifying property rights and speeding up enforcement of court rulings. However, weaknesses in the judiciary are still impeding the proper functioning of market mechanisms.

**Financial sector development**

The assets of the banking sector accounted for some 61% of GDP in mid 2007, compared with some 50% a year before. In view of the relatively high number of banks (19 banks and 12 savings banks), the sector's asset concentration still can be considered to be moderate, with the five largest banks holding some 75% of the sector's assets and deposits. In May 2007, a foreign bank became the majority owner of a medium-sized local bank, which should foster competition in the sector. The share of state ownership in this sector is low, at some 7% of the sector's assets, mainly consisting of a majority share in one development bank (5% of the sector's assets) and a limited number of remaining minority shares in other private banks. Credit to the private sector rose by about 30% in 2006, giving a credit-to-GDP ratio of 26%, compared with 24% at the end of 2005. This trend continued during 2007, bringing the credit-to-GDP ratio close to 30%. The range of financial instruments has been further diversified, for example by issuing three-year treasury bonds for the first time. A new banking law was adopted at the end of 2006, facilitating establishment of branches
of foreign banks and bringing the sector's supervisory and prudential standards closer to international norms. Overall, the banking sector has developed further.

Interest rates on the benchmark central bank bills have fallen by about half a percentage point and rates on treasury bills by nearly one percentage point. Private-sector lending and borrowing rates have been declining by up to 1 percentage point during the last 12 months, while the spread between lending and borrowing rates has narrowed, to some 5 percentage points, compared with 6.5 the year before. The quality of the credit portfolio has improved, with the share of non-performing loans in the total credit portfolio falling from 10.9% at the end of 2005 to 6.4% by the end of June 2007. Capitalisation of the sector is still relatively high, with a capital adequacy ratio of 18% end June 2007, compared with some 21% a year before. Small banks have a high capital adequacy ratio of some 50% on average, while large banks have a ratio of around 12%. The profitability of the sector is continuing to improve. End June 2007, returns on assets and equity stood at 2.4% and 19.3% respectively. Market capitalisation of the 39 private and publicly owned companies currently listed on the Macedonian stock exchange rose from about 20% of GDP in mid-2006, to 29% end of 2006 and to some 84% by mid-2007. Overall, the size of the non-banking financial sector has increased, but the level is still low.

The size of the financial sector remains small, but significant progress has been made on deepening financial intermediation, increasing competition on the financial market and strengthening the legal framework for the sector. Overall, the situation in and stability of the financial sector have improved further.

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

**Existence of a functioning market economy**

The former Yugoslav Republic of Macedonia has maintained macroeconomic stability. It has made significant progress on reducing its external vulnerability and further lowering barriers to market entry and exit. It has adopted legislation to put into action major structural reforms. However, a fully functioning market economy is still impeded by weaknesses in the judiciary, a still insufficient legal certainty and a considerable number of unsettled property disputes. The high unemployment rate points to structural weaknesses and inadequate functioning of the labour market.

**Human and physical capital**

The authorities have stepped up their efforts to align the education system with international standards. Recent amendments to the laws on primary and secondary education include the extension of primary education to nine years and making compulsory as from 2008/2009 three additional years of general or vocational and educational training in secondary education, the introduction of two compulsory foreign languages and computerisation of the education system. The authorities have markedly increased the budget for modernisation of education, although from a low base. Despite these efforts, the overall level of education and training of the labour force still need to be upgraded in order to improve not only labour mobility but also the competitiveness of the country as a whole. Furthermore, equal access to education in all regions is not yet guaranteed in practice. Overall, substantial measures have been taken to improve education, which will have positive effects on human capital.

Job creation has improved. Labour contracts have become more flexible as a result of the new labour code adopted in 2005. Furthermore, active labour market measures have also
been intensified. These have helped to increase employment. However, unemployment has remained very high. In particular, a large part of unemployment is structural, mainly affecting the young and poorly qualified. Furthermore, the current system of calculating social contributions does not yet take into account the new introduced concept of part time work, which creates a significant disincentive of registering low wage or part time employment. Overall, the labour market has become more flexible, but the supply and demand mismatch is still sizeable.

Overall, private and public investment remained relatively low during the last year, reflecting a still difficult business environment and high financing costs. The quality of transport networks has suffered from two decades of underinvestment. Upgrading of the overall infrastructure system has started for projects related to European transport corridor X. Division of the railway company into two operating companies has been completed. The next step planned is the sale of the transport company. Overall, the share of investment in GDP has remained relatively low, in particular in view of the country's need to catch up with international standards.

FDI inflows returned to the previous levels of around 1% to 2% of GDP during the second half of 2006 and the first half of 2007. The main foreign investors are from the EU. The new government has launched a programme to attract FDI, for example by establishing free economic zones. So far the impact of these zones on FDI has remained limited. Greenfield FDI inflows also remain limited. In general, unclear property rights, slow legal procedures and fragmented responsibilities between the central and local governments are impeding FDI. Public research and development expenditure was raised to 1% of GDP in 2006. Overall, infrastructure continues to require repair and modernisation.

Sector and enterprise structure

The economic structure is gradually moving towards a larger contribution by manufacturing and trade, while the share of agriculture in the economy is declining. The number of new enterprises, and in particular of SMEs, has increased markedly. However, the informal economy has remained sizeable, affecting the competitiveness of the economy as a whole. Furthermore, provision of collateral for credit is impeded by the low degree of real-estate registration, and slow legal and administrative procedures are delaying structural change. Overall, the business environment for SMEs appears to have improved.

State influence on competitiveness

Direct state influence is relatively small and, following the establishment of the Commission for Protection of Competition in 2005, the institutional set-up is in place. However, establishment of a level playing field between market players appears to be impeded by the sometimes insufficient independence and resource endowment of the country's regulatory and supervisory agencies. The authorities have taken the first steps to reduce indirect state aid in the form of non-cost-recovering energy prices and of payment arrears. However, these distortions have not yet been fully addressed. Furthermore, the new government appears more active in directly intervening to promote domestic and foreign investment. In some cases, those interventions can lead to distortions in the competitive positions of market participants. Overall, the state's influence on competitiveness is rather limited, although the new government has been demonstrating a greater willingness to actively promote domestic and foreign direct investment. Indirect state aid is still leading to distortion of relative prices.
Economic integration

The country has a small and open economy, in which total trade in goods and services accounted for around 100% of GDP in 2006. The country's main trading partners are the EU and the neighbouring countries in the Western Balkan. During the first eight months of 2007 about 67% of all its exports went to EU-27, while about 50% of its imports came from EU-27. Trade integration with the Western Balkan region remains significant, accounting for 28% of the country's exports and 11% of its imports. In 2006, the country concluded a number of free trade agreements, including with Kosovo, and it joined the new CEFTA agreement, which became operational in mid 2007. The export structure is still highly concentrated on a limited range of products, with textiles and clothing accounting for about 24% of total exports and manufactured iron and zinc products for some 26%. Overall, trade integration is well advanced, but still concentrated on a few price-sensitive products.

International price competitiveness has improved slightly during the last half year, benefiting again from low inflation and a nominally stable exchange rate against the euro. The real effective exchange rate remained largely unchanged in 2006 and the first half of 2007, while overall labour productivity deteriorated due to the relatively strong increase in registered employment. Real wage increases remained in line with productivity growth and unit labour costs decreased slightly in 2006. Overall, price competitiveness has remained stable, while labour productivity has decelerated. The country's per capita income, measured in purchasing power standards, rose to 27% of the EU-27 average in 2006, compared with 26% the year before.

3.4. Conclusions

The economy of the former Yugoslav Republic of Macedonia registered a markedly accelerated growth. Macroeconomic stability has been maintained and structural reforms have further progressed, but the persistence of very high unemployment remains a major cause of concern. Institutional weaknesses and deficiencies in the rule of law still hamper the smooth functioning of the market economy and affect the business climate.

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

The country has maintained a broad consensus on the essentials of economic policies. As a result of an appropriate policy mix, macroeconomic stability and predictability have been maintained. The country's growth performance has improved although there remains scope for more robust growth. Inflation has remained low. The current account was close to balance. However, unemployment has remained particularly high. FDI remained relatively low, after a substantial privatisation related inflow in 2006. The authorities intervened more actively in the economy, by lowering the tax burden, improving revenue collection and increasing expenditures. However, overall, fiscal accounts were maintained close to balance. Tax collection rates increased due to higher revenues and better collection rates. The relatively low level of public sector debt has been reduced further, which also led to a further lowering of the country's external vulnerability. Price and trade liberalisation are largely completed, and the privatisation of state property has continued. Bankruptcy procedures have been shortened and property registration has been accelerated. Financial intermediation has increased and supervision of the financial sector has been strengthened.
Furthermore, measures have been taken to improve the quality of human capital and to modernise the country's infrastructure. Economic integration with the EU is well advanced.

However, the functioning of the market economy is still hampered by institutional weaknesses. The judiciary continues to be a bottleneck and regulatory and supervisory agencies sometimes lack the necessary independence and resources to fulfil their functions effectively. The degree of legal certainty is still low and administrative inefficiencies impede the proper functioning of the public administration and hamper the business environment. Labour markets are still functioning poorly. The large informal sector, fuelled by persistent weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
4. TURKEY

4.1. Introduction

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

4.2. The existence of a functioning market economy

Economic policy essentials

The Pre-Accession Economic Programme submitted to the Commission in December 2006 adequately reflects needs and commitments to further reform. The authorities largely adhered to economic policy agreed with international financial institutions, as stipulated in particular in the Stand-By Arrangement with the International Monetary Fund (IMF) and in the Country Assistance Strategy with the World Bank, revised in 2006. However, political considerations occasionally caused some reform deceleration. The fragmentation of responsibilities between government bodies is 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. Turkey's further challenge is to lock in the economic success and stability for the future in a consistent, holistic approach.

Macroeconomic stability

Real GDP grew in 2006 by 6.1%, down from 7.4% in 2005. In the first half of 2007, growth decelerated to 5.3%. Domestic consumption slowed down since the second half of 2006 as a result of the monetary policy tightening, which followed the financial turbulences of May-June 2006. The slowdown in domestic demand appears to be partly alleviated by strengthening external demand. Government consumption and investment have been broadly kept under control by tight fiscal policies. Economic growth slowed down slightly, but remained strong.

Strong domestic demand fuelled by rapid credit growth and higher oil import prices led to a widening of external deficits. The current account deficit increased from 6⅔% of GDP in 2005 to 8% of GDP in 2006. In the first half of 2007 however, strong exports contributed to a slight reduction of the deficit to approximately 7.8% of GDP in the first seven months of 2007. Turkey can still comfortably finance its current account deficit and has recently considerably increased its foreign currency reserves as a consequence of high privatisation revenues and rising interest from foreign investors. Moreover the current account deficit was also driven by higher investment, which should over the medium term further enhance the export capacity of the economy. External deficits were sizeable, but the financing became more sustainable.

Even though economic growth has been strong, few new jobs have been created, as employment grew by only 1.3% in 2006. The employment rate hovered around 44-45% in 2006-2007. In particular, the female employment rate remained low at 22-23%. The unemployment rate has remained between 8% and 10%. The skill-mismatch between labour demand and supply, and in particular the cost of hiring and firing continue to hamper job creation. Unemployment was much higher among the young (around 19%) and of a long-
term nature for more than half of job-seekers. The lower unemployment rate in the agricultural sector, where unpaid family workers are incorporated, suggests the existence of large pockets of underemployment in the economy.

### Turkey - Main economic trends

<table>
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<th>2002</th>
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<th>2004</th>
<th>2005</th>
<th>2006</th>
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<td>Gross domestic product</td>
<td>Ann. % ch</td>
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<td>9.0</td>
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<td>6.6</td>
<td>10.1</td>
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<tr>
<td>Gross fixed capital formation</td>
<td>Ann. % ch</td>
<td>-1.1</td>
<td>10.0</td>
<td>32.4</td>
<td>24.0</td>
<td>14.0</td>
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<td>Unemployment</td>
<td>%</td>
<td>10.4</td>
<td>10.5</td>
<td>10.3</td>
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<td>9.9</td>
</tr>
<tr>
<td>Employment</td>
<td>Ann. % ch</td>
<td>-0.3</td>
<td>-0.8</td>
<td>2.0</td>
<td>1.7</td>
<td>1.2</td>
</tr>
<tr>
<td>Wages</td>
<td>Ann. % ch</td>
<td>37.2</td>
<td>23.0</td>
<td>13.4</td>
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<td>Current account balance</td>
<td>% of GDP</td>
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<td>-3.3</td>
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<td>Direct investment (FDI, net)</td>
<td>% of GDP</td>
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<td>0.7</td>
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<tr>
<td>CPI</td>
<td>Ann. % ch</td>
<td>45.0</td>
<td>21.6</td>
<td>8.6</td>
<td>8.2</td>
<td>9.6</td>
</tr>
<tr>
<td>Interest rate (3 months)</td>
<td>% p.a.</td>
<td>50.49</td>
<td>37.68</td>
<td>24.26</td>
<td>20.40</td>
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<td>Bond yield</td>
<td>% p.a.</td>
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<td>N.A.</td>
<td>N.A.</td>
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<td>19,899</td>
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<td>39,867</td>
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<td>1.80</td>
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<td>26.18</td>
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<td>% of GDP</td>
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<td>-5.8</td>
<td>-0.3</td>
<td>0.4</td>
</tr>
<tr>
<td>General government debt</td>
<td>% of GDP</td>
<td>94.3</td>
<td>85.1</td>
<td>76.9</td>
<td>69.6</td>
<td>60.7</td>
</tr>
</tbody>
</table>

Sources: Eurostat, Reuters/Ecowin, National sources, * EC Autumn 2007 forecast

At the end-2006, inflation had increased to about 10% (from 8% early 2006) driven by various issues, including the exchange rate pass-through, rigidities in services prices and high energy prices. This rate was significantly higher than the central bank's year-end target of 5%. Inflation started to come down again in the second quarter of 2007, to 7.1% in the year to September 2007. Unprocessed food, oil prices, exchange rate volatility and fiscal policy loosening are major risks for the inflation trend. In sum, the downwards trend in inflation decelerated.

The Central Bank of Turkey (CBT) reacted firmly to the financial turbulence of mid 2006 by increasing policy rates by 425 basis points. Consequently, Turkish asset prices have bounced back and recovered most of the ground lost. In mid-September 2007, policy rates were unexpectedly cut by 25 basis points. Market participants saw the CBT actions as a reaffirmation of the independence of the bank and a signal of its continuing commitment to the disinflation process. The CBT implemented a new policy framework of inflation targeting as from 1 January 2006 in order to make its policy more transparent. It uses short-term interest rates as a main instrument. CBT's commitment to disinflation has brought about credibility after a very turbulent period and was appreciated by financial markets.

Consolidation of public finances has largely been on track, even though ahead of the parliamentary elections, fiscal consolidation has weakened slightly. The 2006 primary surplus target of 6.5 of GDP (IMF methodology) was reached, helped by buoyant one-off revenues. Revenues rose strongly by 27% annually, but spending in health, agriculture, and personnel was higher than budgeted. In 2006, the general government budget surplus amounted to 0.4% of GDP (according to ESA 95, the EU methodology) compared with a (revised) deficit of 0.3% in 2005. The budget for 2007 is designed to achieve a similar a
public sector primary surplus. Fiscal targets for the central budget for the first half of 2007 have been missed by less than 1 percentage point of GDP, due to some election spending. Functional allocations of public expenditures could be improved in terms of efficiency and cost containment. The implementation of the social security reform is stalled. All in all, fiscal policy loosened slightly, but remains strong.

A significant primary surplus and strong GDP growth have further reduced the debt-to-GDP ratio. General government gross debt fell markedly to 60.7% of GDP by end-2006 from 69.6% the year before. Turkey has also launched various sovereign bonds on the international market. By mid-2007 the share of public debt denominated in domestic currency had risen to around 65%, up from 55% in 2003. Furthermore, debt has been shifted further to fixed interest rates and debt maturities have been lengthened, in particular on domestic borrowing, to almost 40 months by mid-2007. However, debt remains relatively high and the debt service dynamics still remains closely related to movements on global financial markets. The risks of the public debt structure and maturities to macroeconomic and financial stability have been further reduced.

The administration has put emphasis on the implementation of adopted legislation, in particular the Public Financial Management and Financial Control Law (PFMC). Several coordinating and controlling bodies have been created within the Ministry of Finance, and accountability, efficiency and transparency have benefited substantially. This resulted in, for example, an improvement of the budget preparation, as illustrated in the Medium-Term Fiscal Framework (2008-2010) which has been adopted by the authorities in June 2007. The law on PFMC is broadly consistent with EU standards on internal controls. Some key elements are still lacking, in particular the Turkish Court of Accounts Law, which would enhance transparency and provide significant support for anti-corruption efforts. Overall, measures to increase fiscal transparency have continued.

**Interplay of market forces**

The government has confirmed the independence of regulatory and surveillance agencies, although some imperfections persist. But despite the regulatory framework, government authorities have a tendency to set the prices in transport sector, in particular in the civil aviation. Ahead of the Parliamentary elections, the government did not allow global price changes have an impact on electricity consumption and natural gas prices. Cross-subsidies continued in the electricity sector. There remained large arrears regarding the utility bills of public institutions and local administrations. Although the regulatory framework is in place, the liberalisation of backbone services, in particular in the energy sector was stalled.

The share of administrated prices in the consumer price index (CPI) basket amounts presently to 10.2% of the total weight of the CPI basket. Price reform is not completed, and in particular electricity prices are far from reflecting costs and include cross-sector subsidies. In early 2007, the government refused to increase energy prices, which have been frozen for several years in spite of sharp increases in global prices. Price liberalisation is fairly advanced, but has not made much further progress.

In 2006, 87 privatisation deals were concluded. Their proceeds corresponded to 2% of GDP. The privatisation process slowed down in 2007. Two real estate sales were conducted in Istanbul. A 25% stake of state-owned Halkbank was sold through initial public offering. Petkim (petrochemicals) was privatised in July 2007. The government postponed the privatisation of electricity distribution assets after the tender process started. Energy, banking, petrochemicals, and air transport sectors are still awaiting some major privatisation. The agenda is not yet finished as 5% of GDP (and 15% of value added in
manufacturing) is still accounted for by state enterprises. Privatisation proceeds were significant, but the agenda is not yet finished.

**Market entry and exit**

In 2006, the business registration process was further streamlined. As a result, it now takes on average only 9 days to open a business, one of the fastest registrations in the world. Almost 100,000 enterprises were established in 2006, almost unchanged from the previous year. However, registration costs (estimated about € 750) are relatively high. Some fees are rather intransparent, such as those for the official registration of a company’s articles and accounting books. Fees related to the trade registry are significant. Closing a business is expensive and time consuming in Turkey. Insolvency procedures take about 6 years and recovery rates are very low at 10% on average. Therefore, progress in removing exit barriers remains weak. Turkey has established most of the legal framework of a market economy, but must ensure further implementation.

**The legal system**

The legal system, including the regulation of property rights, is in place. However, the implementation of laws and contracts should be further improved. In particular the commercial courts work relatively slowly and the time lag between the adoption of framework legislation and its implementation is often long. Moreover, the enforceability of the decisions of the autonomous authorities and of courts continues to prove difficult, including with foreign investors. Training of judicial personnel is not always sufficient and hampers a swift settlement of commercial cases. The implementation of the legislation on intellectual property rights is not adequate.

**Financial sector development**

The banking sector has made significant progress in developing financial intermediation, encouraged by the strong economic growth and improvements in the regulatory framework. In spite of the volatility in several periods during 2006-2007, financial markets have shown remarkable resilience. After being hit by the financial turbulence in mid-2006, financial sector's risk ratios improved in the second half of 2006, driven mainly by the recovery in market prices. Private credits grew from 25% of GDP in 2005 to 32% by mid-2007. Total bank assets have expanded from 81% of GDP in early 2006 to almost 90% by mid-2007. In 2006, the sector benefited from a rapid revival of investor appetite for Turkish assets. Increased foreign participation in the banking sector has enhanced competition. Majority-owned foreign banks accounted for about 25% of Turkish banking assets in mid-2007, compared with 12% in 2005. Financial intermediation costs are still high at almost one-third of the loan interest rates and remain a major impediment to efficient intermediation. Overall, the banking sector is in good shape.

Supervision standards in the banking sector were significantly enhanced, due to the implementation of the banking Law adopted in 2005. Most of the by-laws - in particular those transferring the regulatory and supervisory power for financial holding companies, leasing companies, factoring companies and consumer finance companies to the Banking Regulation and Supervisory Agency - have been put in place in 2006-2007. However, the prudential regulatory framework's effectiveness is still hampered by the absence of a regulation on country and transfer risk as well as on interest rate risk in the banks' books. In addition, risks are not always assessed on a consolidated basis, in particular in the case of mixed conglomerates and integrated supervision of entire banking groups. Banking concentration can be qualified as moderate (just over 60% of total banking assets are with
the five largest banks). In sum, supervision of the financial sector has been further strengthened.

The main non-bank financial institutions, i.e. insurance companies, pension funds, leasing and factoring firms experienced impressive growth, yet their total assets only amount to 10% of GDP in mid-2007. A new mortgage law was adopted in February 2007, and a new Insurance Law was passed by the Parliament in June 2007. This new legislation aims at facilitating more flexibility and security in the financial sector's expansion. Rapidly growing, albeit still undercapitalised, equity markets are increasingly helping the corporate sector to raise funds. For the first time in a decade, a Turkish Lira denominated corporate bond was launched in mid-2006. Non-bank financial institutions are small, but increasingly dynamic and rapidly expanding.

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

Existence of a functioning market economy

Macroeconomic stability has been largely preserved. Recent financial market turbulence added some uncertainty to the business environment, but at the same time underlined the economy's improved shock resilience. The authorities have improved the investment climate by reducing administrative barriers for firms’ entry and operation; reducing and simplifying the personal and corporate income taxes and improving effectiveness of the tax administration and corporate governance, and privatising many state owned enterprises; and focusing on improving corporate governance. However, certain features remained which distort the functioning of markets, such as low transparency regarding state aid and market exit.

Human and physical capital

The authorities have designed a new educational reform programme as a key part of the National Development Plan (2007-2013). This programme has two key pillars for education, modernisation and reform: increase the responsiveness of education to the demand; and enhance the educational system. However, the challenges are significant. While the top students in Turkey perform well, the vast majority of Turkish students perform at the lowest proficiency levels in basic competencies and problem solving. The distribution of Turkish scores is highly skewed toward the lower levels of proficiency. Participation in higher education remains low relative to international standards. Around 40% of 20 to 24 year olds had a secondary degree and about ten percent of school-age children are still not enrolled in primary schools. Reforms and increased spending on education are generating some positive impact on educational attainment, but significant problems pertain.

Labour force participation rates are low, particularly for women and older people, and increased only marginally in 2006 and 2007. The fast-growing working-age population and the sectoral shift out of agriculture create a strong demand for new jobs, but due to the limited diversity of the rural economy, a skill mismatch and labour market rigidities major imbalances pertain. There have been few systematic efforts to reduce the substantial employment in the informal economy. No significant changes have been made to the labour framework. The legal focus remains on protecting jobs, while less than 4% of the unemployed workforce get unemployment benefits. The non-wage costs of hiring labour remain large. Active labour market policies do not have a broad scope and have had limited success in reducing unemployment. Corporate income tax rates are high and complex,
although reductions have recently been introduced. Taxes on labour (personal income tax rates –PIT- and social security contributions) are also relatively high. This system contributed to creating incentives for self-employed entrepreneurs to remain in the informal part of the economy. In 2006, the top PIT rate was reduced from 40% to 35% and the number of brackets down to four. Overall, the situation in the labour market remains challenging and policy responses have been limited.

Private gross fixed capital formation grew by around 30% in 2006, but growth fell to 7% in the first half of 2007. Private capital formation amounted to around 17% of nominal GDP. FDI inflows increased significantly in 2006, to 4.9% of GDP. Around 85% of these FDI inflows were equity investment and around 14% real estate purchases. As a result, the FDI stock reached € 37.3 billion (about 20% of GDP), with almost half (46%) due to 2006 inflows. Most of the equity investments in 2006 occurred in financial services (40%), communication (36%), wholesale and retail trade (9%) and chemicals (3%). FDI inflows remained strong, as they amounted to about 5% of GDP in the first half year of 2007.

Infrastructure investments have for many years been hampered by the need for consolidating public finances and the failure to reduce lower-priority spending. No major investments have been initiated. Although the official target of the government is to increase the research and development expenditures to 2% of GDP by 2010, realisations remain much lower, as Research and development expenditure amounted to just 0.7% of GDP in 2006. Inadequate infrastructure, including in the area of power supply, increasingly affects economic activity. Gross electricity consumption growth has averaged some 7% in each of the past four years, and no extra-power generating capacity has been constructed. Improvements in infrastructure have been modest.

**Sector and enterprise restructuring**

The share of agriculture in employment decreased from 30% of total employment in 2005 to 27% in 2006. Jobs were created in the industrial sector (including construction) and its share in the total labour force rose from 24% to 26.5% in 2006. Employment in the services sector increased from 42% in 2005 to over 47% in 2006. For the first time in five years, job creation in industry and services fully compensated for the reduction in agricultural employment. The relative size of agriculture fell from 10.3% in GDP in 2005 to 9.2% in 2006. The industry (including construction) proportionally remained stable at roughly 31% of GDP. Services increased to about 60% of GDP. The informal economy has remained sizeable, affecting the competitiveness of the economy. Overall, the process of structural transformation of the economy accelerated.

SMEs in Turkey account for 99% of total enterprises and 80% of total employment. However, SME ratios for capital investment (38% of the total), value added (26%), exports (10%) and bank credit (5%) point at low labour productivity, insufficient access to finance and barriers to enter foreign markets. Informality is widespread throughout all corporate sectors, but particularly amongst SMEs. In sum, SME have insufficient access to finance and are often operating in the grey economy.

Restructuring was supported by privatisation in some areas, such as the telecom sector. Progress was achieved in restructuring and preparing privatisation of the state owned banks, including by launching the IPO of 25% of Halkbank, but the process has been delayed repeatedly. Efforts to restructure and liberalise the energy sector also fell behind schedule. Some of the main outstanding problems in the sector are related to cross-subsidies and large distribution losses. In the private sector, strong productivity gains indicated a largely successful restructuring process. Enterprise restructuring continued at a mixed pace.
State influence on competitiveness

Overall, the role of the state as an active player in the markets has been further reduced. The work of the Competition Authority continued. It is widely appreciated by economic agents and its role was further strengthened by the privatisation process. Transparency in the corporate sector improved and accounting standards were upgraded although the new legislation has not yet fully implemented. The absence of a transparent monitoring of state aid and of supporting policies to decrease distortions adversely affects competition and competitiveness in the economy. Public procurement policies continued to be undermined by the exceptions made to the regulatory framework.

Economic integration with the EU

Turkey's trade openness increased marginally. Exports and imports of goods and services totalled 63% of GDP in 2006. The share of exports destined for the EU declined from 52.3% in 2005 to 51.6% in 2006, as exports to neighbour countries benefited from increased stability in the region. Imports from the EU as a share of total imports also declined, from 42.1% to 39.3%, mainly due to the rising import bill on energy, which Turkey imported almost exclusively from non-EU countries. The EU remained Turkey's largest trading partner, but other markets are gaining in importance. In 2006, FDI-inflows from the EU amounted to 82% of total FDI, compared to 58% a year earlier. The FDI-stock totalled about 20% of annual GDP of which roughly two thirds originated from EU countries.

Labour productivity growth in the manufacturing sector further increased in 2006 and 2007, from almost 15% to less than 5% annualised. During the same period production per working hour also increased by 5.3%. Productivity also continued to improve in the public sector, where the number of employees decreased by 6% while productivity increased by almost 10%. The pace at which the real effective exchange rate increased (based on Unit Labour Costs) slowed down considerably. Productivity growth slowed down in most sectors of the economy.

Turkey's average per capita income, measured in purchasing power standards, reached in 2006 nearly 30% of the EU-27 average in 2007, slightly up from the corresponding level in 2005.

4.4. Conclusions

The Turkish economy continued to grow rapidly, with high inflows of foreign investment. The monetary and fiscal policy mix was broadly adequate. Inflationary pressures, growing external imbalances and weaker fiscal discipline in 2007 may affect macroeconomic stability. Structural reforms have slowed down and labour market rigidities hamper job creation.

As regards economic criteria, Turkey can be regarded as 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 implements its comprehensive reform programme to address structural weaknesses.

Economic growth remained robust, in large part due to higher exports, and business confidence was strong. The new government expressed strong commitment to fiscal consolidation and structural reform. A strong lira and fiscal discipline have reduced the public debt, despite high borrowing costs and some financial market turbulence. The central bank has been conducting a cautious and responsible monetary policy. FDI grew sharply,
notably in the form of purchases of Turkish companies by foreign entities, and has played a
greater role in reducing risks related to macroeconomic imbalances.

However, tax relief and higher infrastructure spending led to fiscal loosening in 2007. Corrective measures are needed to reach the budget target in 2007. Inflationary pressures have increased – in particular due to food and services prices and wages - and in the absence of major policy changes the inflation target for end 2007, set by the government and the central bank, might not be met. A large part of the widening current account deficit is still financed by short-term capital inflows. The fiscal pressure on labour remains very high and deters job creation in the formal sector. Structural rigidities in the labour market hamper job creation, and hamper an increase in employment of women. The pace of privatisation has slowed down. Human capital remained to a large extent ill-adapted to the needs of a rapidly growing and developing economy, in particular in export-oriented sectors. Regional disparities remain high. The lack of transparency in state aid remains detrimental to effective economic policy making. Planned reforms in the social security system and in the energy sector have been postponed. The large informal sector, fuelled by weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
5. ALBANIA

5.1. Introduction

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

5.2. The existence of a functioning market economy

Economic policy essentials

The first economic and fiscal programme for 2006-2008 was submitted by the authorities in December 2006. It is a broadly consistent economic policy document outlining a fundamentally sound medium-term framework. Nevertheless, as the programme gave no indication of important fiscal measures to be implemented as of July 2007, the validity of the fiscal framework remains unclear. A national strategy for development and integration for 2007-2013 with a strong emphasis on economic reform is being prepared. Cooperation with international financial institutions continued to be a firm anchor for economic policies. In July 2007, the International Monetary Fund (IMF) completed its third review under the current programme and all the quantitative targets and structural conditions were met. Overall, domestic consensus on the fundamentals of a market economy was broadly maintained.

Macroeconomic stability

In 2006, real GDP grew by 5%, down from 5.6% in 2005, driven mainly by domestic demand fed by booming credit and significant inflows of remittances. Despite government action to increase power imports after the first energy crisis at the end of 2005, Albania continued to suffer severe disruptions in electricity supply in 2006 and 2007. In 2006, these electricity shortages had little impact on economic growth and the current account, as electricity imports were not particularly large. However, as electricity shortages have been worsening in 2007, the impact of electricity imports on the current account will be stronger.

The current account deficit widened from 7.3% of GDP in 2005 to an estimated 7.6% of GDP in 2006. This was mainly a result of higher electricity imports. The trade deficit increased to 23.1% of GDP in 2006 and further widened by around 24% in the first half of 2007 compared with the same period last year. Growth in exports of goods and services, at around 21%, outpaced growth in imports of goods, at approximately 19.5% in 2006. Import coverage, i.e. exports as a percentage of imports, therefore increased slightly to 49% in 2006. The positive trend, with exports growing faster than imports, continued in the first half of 2007, with annual growth rates of 27% and 24% respectively. Income from tourism increased by 16% in 2006 and exceeded the value of exports of goods by 28%.

Financing of the trade deficit continued to depend largely on significant remittances and other current transfers from abroad, estimated at around 13% of GDP in 2006 or approximately 55% of the trade deficit. Foreign direct investment (FDI) rose by 16% in 2006 over 2005, to an estimated 3.6% of GDP for 2006. The government's external debt was estimated at around 17% of GDP at the end of 2006, equivalent to around 31% of total public debt. Gross reserves continued to rise throughout 2006 and climbed to around 4.5
months of imports of goods and services. Overall, external deficits widened further, mainly due to difficulties in the energy sector.

### Albania - Main economic trends

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross domestic product</td>
<td>Ann. % ch</td>
<td>4.2</td>
<td>5.8</td>
<td>5.7</td>
<td>5.8</td>
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<tr>
<td>Private consumption</td>
<td>Ann. % ch</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
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</tr>
<tr>
<td>Gross fixed capital formation</td>
<td>Ann. % ch</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>Unemployment</td>
<td>%</td>
<td>16.0</td>
<td>15.2</td>
<td>14.7</td>
<td>14.3</td>
<td>13.9</td>
</tr>
<tr>
<td>Employment</td>
<td>Ann. % ch</td>
<td>-14.1</td>
<td>0.9</td>
<td>-0.4</td>
<td>0.9</td>
<td>4.2</td>
</tr>
<tr>
<td>Wages</td>
<td>Ann. % ch</td>
<td>16.0</td>
<td>14.7</td>
<td>14.4</td>
<td>9.9</td>
<td>-7.0</td>
</tr>
<tr>
<td>Current account balance</td>
<td>% of GDP</td>
<td>-8.5</td>
<td>-5.6</td>
<td>-4.4</td>
<td>-7.5</td>
<td>-7.0</td>
</tr>
<tr>
<td>Direct investment (FDI, net)</td>
<td>% of GDP</td>
<td>3.0</td>
<td>2.6</td>
<td>4.0</td>
<td>3.4</td>
<td>3.3</td>
</tr>
<tr>
<td>CPI</td>
<td>Ann. % ch</td>
<td>5.2</td>
<td>2.4</td>
<td>2.9</td>
<td>2.4</td>
<td>2.4</td>
</tr>
<tr>
<td>Interest rate (3 months)</td>
<td>% p.a.</td>
<td>9.49</td>
<td>8.87</td>
<td>6.78</td>
<td>5.55</td>
<td>5.49</td>
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<td>Bond yield</td>
<td>% p.a.</td>
<td>N.A.</td>
<td>11.4</td>
<td>8.2</td>
<td>8.2</td>
<td>7.3</td>
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<td>Index</td>
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<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
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<td>Exchange rate LEK/EUR</td>
<td>Value</td>
<td>131.66</td>
<td>136.80</td>
<td>127.17</td>
<td>123.73</td>
<td>122.76</td>
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<td>Nominal eff. exchange rate</td>
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<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>General government balance</td>
<td>% of GDP</td>
<td>-6.6</td>
<td>-4.5</td>
<td>-5.1</td>
<td>-3.6</td>
<td>-3.2</td>
</tr>
<tr>
<td>General government debt</td>
<td>% of GDP</td>
<td>65.3</td>
<td>61.7</td>
<td>56.6</td>
<td>56.7</td>
<td>56.7</td>
</tr>
</tbody>
</table>

Sources: Eurostat, Reuters/Ecowin, National sources, IMF

Data suggest that the unemployment rate continued to fall to 13.8% in 2006, compared with 14.2% in 2005. The downward trend continued in the first quarter of 2007, bringing a further drop in the unemployment rate to 13.6%. The highest increases in the number of new employees were observed in the mining, manufacturing and services sectors. Long-term unemployed made up 65% of the total registered unemployed. Overall, the level of registered unemployment continued to decline.

The primary objective of the exchange rate regime of Albania remained to maintain price stability. This is pursued by a policy of implicit inflation targeting and an independent float. The Bank of Albania occasionally intervened in the foreign exchange market with the objectives of smoothing temporary fluctuations and accumulating foreign currency reserves. An annual inflation rate of 3% with a fluctuation band of ±1% has been set as the objective, to be implemented in the central bank’s strategy by means of changes in the repurchase rate. The lek remained relatively stable against the euro throughout 2006. After depreciating slightly, by around 2.5% against the euro over the first four months of 2007, it gradually returned to its year-opening level and, by September, appreciated slightly further. Discussions at the Bank of Albania on a possible change in its monetary policy framework towards an explicit inflation targeting regime have progressed.

Annual growth of the broad money in circulation accelerated to 16.3% at the end of 2006 and stood at 16% in August 2007. Average annual inflation reached 2.4% in 2006 but accelerated to 4.4% in September 2007 driven by rising prices for agricultural products. Following the hikes of the main policy rate in July 2006 and November 2006, the Bank of Albania further tightened its monetary policy stance in June 2007 by raising its main policy rate by another 25 basis points. This also aimed at containing inflation expectations on the back of rapid credit growth and relatively high growth rates in money supply. Overall,
monetary policy remained credible, keeping inflation within the fluctuation band around the set target.

In 2006, budget performance benefited from a favourable macroeconomic environment. The solid economic growth, combined with the implementation of reforms aiming at improving tax administration and reducing tax evasion, led to a solid increase in revenue collection. In addition, capital expenditure was lower than planned (by approximately 17%). This was partly a result of capacity constraints in some ministries and weak procurement management. The programmed general government deficit of around 4% of GDP in 2006 was therefore undershot. Instead the deficit stood at 3.2% of GDP.

The budget for 2007, as adopted by parliament in November 2006, plans a deficit of 4.8% of GDP, excluding proceeds from potential privatisations. Revenue is programmed at 26% of GDP, exceeding 2006 budget projections by around 10%. Expenditure is programmed at 30.6% of GDP, growing by about 12.5% over the 2006 budget. The priority sectors remained infrastructure, health care and education, each accounting for around 3% of GDP. Average public-sector wages increased by 14.9% year-on-year in 2006. Over the first half of 2007, the budget recorded a surplus of about 1% of the full-year projected GDP, largely due to underspending in the capital budget. In the light of these favourable developments on the expenditure side and of the proceeds from privatisation of Albtelecom, half of which will be used to reduce debt, the authorities agreed with the International Monetary Fund on a supplementary budget for the second half of 2007. Similarly to 2006, a large part was allocated as additional productive investment, mainly in infrastructure projects. In addition, a flat personal income tax of 10%, with 0% levied on the first 10,000 lek for salaries up to 30,000 lek, entered into force in August 2007. Overall, the revenue performance was broadly in line with the targets and budget implementation improved.

The public debt-to-GDP ratio has been substantially reduced over recent years, from 71% at the end of 2000 to below 56% at the end of 2006. However, the level of domestic public debt remains relatively high, at about 39% of GDP at the end of 2006. The average maturity of domestic public debt increased from 195 days in 2005 to 242 days at the end of 2006. Nevertheless, it still remains relatively short and efforts to lengthen it need to be accelerated. The public-debt management strategy was approved by the government in early 2007 and a new directorate for debt management has been established under the Ministry of Finance. The authorities successfully issued the first 5-year domestic bond in November and a first euro-denominated bond in December 2006, broadening the range of instruments available and the investor base. However, the administrative and risk-management capacity of public-debt management need to be further strengthened to reduce the outstanding deficiencies and vulnerabilities resulting from the current debt structure.

Solid progress on implementing public finance reforms continued. The authorities completed the public finance strategy for 2007-2013. The strategy clearly identified the main priorities, related policies and measures to increase the efficiency of public finance over the medium term. Nevertheless, the impact of further reforms on public finance sustainability needs further discussion. Overall, public finance reforms have further advanced but fiscal risks remain.

The tightening monetary policy of the Bank of Albania continued to be geared towards price stability. Further fiscal adjustment was pursued in 2006, while expenditure grew in 2007 as favourable revenue performance allowed higher spending. Deficit and debt targets agreed with the IMF were adhered to or overachieved. A supplementary budget was approved in July 2007 raising investment expenditure in particular. In general, the macroeconomic policy mix again remained broadly adequate.
**Interplay of market forces**

The private sector's share of GDP was estimated at around 80% in 2006. The share of the private sector in total employment remained stable at around 82% in 2006. Within that, agriculture accounts for 71% of the total private-sector employment. The private sector further expanded, also on the back of acceleration of the privatisation process. In July 2007, parliament endorsed the sale of the 76% stake in Albtelecom, the public telecommunications operator. This was the most important privatisation operation since 2004. The proceeds totalled EUR 120 million, equal to around 1.5% of the projected 2007 GDP. However, state ownership remains significant in utilities, such as KESH (the state power utility), Albanian Refining and Marketing Oil and Albpetrol-One, recently formed by merging Albpetrol and Servcom. Some progress has been achieved on preparing the ground for privatising the distribution arm of KESH. The government's objective of selling a stake in the state-owned insurance company has not yet been achieved. To sum up, after significant delays in the privatisation agenda in 2006, progress with privatisation has gained new momentum since early 2007.

**Market entry and exit**

Solid progress has been made on computerisation of the data on registered existing businesses. The national registration centre for businesses, which came into operation in September 2007, is intended to serve as a one-stop-shop. The average time needed to set up a business was 36 days. The number of new businesses registered increased considerably, by around 46% in 2006, equivalent to over 14,000 new registrations. The total number of registered businesses stood at almost 78,000 at the end of 2006. However, the costs of starting and closing a business remain relatively high. Overall, company registration procedures have started to improve, but remaining administrative inefficiencies continue to hamper market entry and exit.

**Legal system**

The establishment of a new joint investigative unit to fight economic crime and corruption in May 2007 is a positive development, although its operational capacity has so far been weak. The judicial system suffers from non-transparent and inefficient court proceedings. Political and other undue interference in the system occurred. While some progress has been made with enforcement of court rulings and establishment of property rights, the overall efficiency of the judicial system and the resulting implementation of law remain low.

**Financial sector development**

The financial sector is dominated by commercial banks, practically all in private ownership. The degree of market concentration remains fairly high as the group of the five largest banks dominates the market with about 75% of total assets in July 2007. This is equivalent to a decrease of concentration by almost 4% since the end of 2005. The average return on assets remained stable at 1.4% in 2006, while the average return on equity decreased slightly to 20.2% in 2006 from 22.2% at the end of 2005. The average capital adequacy ratio stood at 18.1% at the end of 2006, 0.5 percentage points lower than a year earlier. This is mainly attributable to accelerated growth in risk-weighted assets, on the back of rapid credit growth. The capital adequacy ratio varied substantially between banks, with the lowest recorded at 12.4%. Stress tests point to solid resilience of the banking sector to possible shocks resulting from movements in exchange rates and interest rates and
deterioration of credit quality. Overall, the privately owned banking sector is growing and is generally sound.

The annual growth of credit (74% in 2005) moderated somewhat to 57% in 2006. It increased to 58% during the first four months of 2007. Credit denominated in Albanian lek recorded the highest growth at around 78% in 2006, while credit in foreign currency grew by 47%. The level of financial intermediation remained relatively low. At the end of 2006, total credit equalled 31% of total banking assets or 37% of total deposits. Outstanding credit added up to 22% of GDP in March 2007, while credit to businesses made up 66.5% of the credit portfolio of banks. The share of non-performing loans to total credit increased to 3.1% by December 2006, compared with 2.3% at the end of 2005. In short, credit continued to expand strongly.

In order to keep credit growth at sustainable levels, prudential supervision was strengthened in December 2006. The Regulation on credit risk management was amended, establishing higher capital requirements for banks that record credit growth exceeding the set benchmarks. In addition, the new banking law was adopted and entered into force in June 2007. Preparations for establishing the credit information bureau and completing draft legislation improving execution of collateral have been continuing. The regulatory framework for banking supervision is, following its recent comprehensive overhaul, well-developed and continuing the process of alignment with international practice.

A restructuring of the financial supervisory authority was approved by parliament in May 2007. The institutional development action plan aims further to reinforce the operational capacity of this institution. The amendment of the insurance law was adopted in early 2007. The pension system remains underdeveloped. Overall, some progress has been achieved in the area of non-banking supervision; nevertheless, scope for stronger non-banking supervision, in particular regarding the pensions industry, remains.

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

Existence of a functioning market economy

Albania's economic growth and stability continued to be relatively strong, despite the negative effects of the energy crises at the end of 2005 and 2006. Nevertheless, the business environment remained very weak and calls for further significant improvements. Outstanding deficiencies of the judiciary, uncertainty about property rights, a high level of corruption, inadequate infrastructure and unreliable energy supply, in particular, continued to hinder economic development and investment.

Human and physical capital

The budget for education, which was at a low level, has been significantly increased in 2007. A new law on higher education was adopted by parliament in May 2007. The labour market continued to face significant challenges, such as relatively slow job creation and high youth and long-term unemployment. The efficiency of labour market policy design and planning remained significantly constrained by the limited statistical capacity and unreliable key labour market indicators.

Gross fixed capital formation is estimated to have increased from 30.3% of GDP in 2005 to 32.6% in 2006. This was mainly a result of rising public investment. The government focused on investment in the energy sector, infrastructure and transport, in particular on
highway construction. Net flows of foreign direct investment (FDI) increased from 3.3% of GDP in 2005 to 3.6% in 2006, equivalent in absolute terms to an increase of around 16%. The telecommunications sector took the largest share of cumulative FDI inflows in 2006 (35%), followed by industry (33%) and services (12%). A new initiative called "Albania – 1 euro" was launched in mid-2006 to stimulate FDI inflows, but follow-up has been limited so far.

The road network is in poor condition and needs further very substantial rehabilitation and extension, notably highway links with the neighbouring countries. Preparation for construction of the Durrës-Kukës-Morinë road and completion of the north-south and east-west national roads gained momentum. About 76% of the budget appropriations of the Ministry of Public Works, Transport and Telecommunications in 2007 were allocated to the national road network. Only 10% of this amount was secured for maintenance, a share insufficient to cover basic maintenance needs. Overall, improving infrastructure remains a challenge.

**Sector and enterprise structure**

The operational and financial performance of the electricity utility KESH deteriorated sharply over the reporting period and only little progress has been achieved to bring the company closer to financial sustainability which requires improving billings and collections. However, under new management, notable progress has been made in collection during the second quarter of 2007. Domestic generation was only partly able to meet local energy consumption needs and, as a consequence, electricity had to be imported. Insufficient interconnection capacity to import the quantities required resulted in power cuts. The fact that retail electricity prices have been kept below import cost levels, leading to reliance on budgetary support, remains a key problem. The frequent power cuts had a negative effect on private-sector productivity and investment activity. As a result, the energy sector remains one of the major risks to macroeconomic stability and to the budget. In short, the energy sector remains highly vulnerable. Vigorous measures to address the key inefficiencies are essential.

The shares of the main sectors of the economy remained relatively stable. The services sector continued to be the main contributor to GDP in 2006 with around 47% (1% less than in 2005), followed by agriculture with around 21%, construction with its gradually increasing share of 16%, industry with 10% and transport on 6%. The informal economy has remained sizeable, affecting the competitiveness of the economy. Small and medium-sized enterprises (SME) generated approximately 64% of GDP in 2006. They account for 99% of the total number of firms and 66% of total employment. It is estimated that 49% of enterprises were active in the trade sector, 24% in the services (non-trade) sector, 11% in industry and 10% in transport. Almost 50% of all active enterprises are operating along the Tirana-Durrës corridor, where around 57% of the total number of employees work. SMEs remained the main contributors to economic growth, employment and poverty reduction.

**State influence on competitiveness**

The overall liberal trade and business environment policies continued to facilitate development of a private-sector-led economy. Nevertheless, large subsidies continued to be provided to public enterprises, mainly to KESH. These subsidies were meant to improve the energy supply and to avoid further deterioration of KESH's financial position, thus reducing the effects of electricity disruptions on economic activity. This, however, places a heavy burden on the budget. Total subsidies and transfers from the budget added up to 0.3% of GDP or 0.9% of budgeted revenue in 2006. Budget support to KESH in 2007 totalled about
0.5% of GDP. Overall, while the authorities did not intervene directly in the development and functioning of the private sector, subsidies to public utilities, however, continued to be relatively high.

**Economic integration with the EU**

The value of Albania's exports and imports of goods and services accounted for about 74% of GDP in 2006, increasing the openness of the economy as compared to 2005 (68% of GDP). The EU is by far Albania's main trading partner. Albania's exports of goods to the EU accounted for around 88% of the total exports of goods in 2006. Imports from the EU accounted for approximately 63% of total imported goods. At the same time, Albania further expanded its trade with its non-EU neighbours. In terms of export structure, the footwear and textile industry products together accounted for around 55% of Albania's total exports of goods.

The real effective exchange rate remained stable in 2006. Due to limited availability and reliability of data on labour productivity and price competitiveness based on real unit labour costs, recent trends in this respect are difficult to discern.

Albania's per capita income, measured in purchasing power standards, totalled around 18% of the EU-27 average in 2006, nearly half a percentage point up from the corresponding 2005 level.

### 5.4. Conclusions

Albania’s economy has continued to expand strongly. Overall macroeconomic stability has been maintained, but external deficits widened further, mainly due to the crisis in the energy sector. Inadequate implementation of the rule of law continues to impede the smooth functioning of the market economy and affects the business climate. Poor infrastructure and unreliable energy supply continued to hinder economic development.

As regards economic criteria, Albania has made progress towards establishing a functioning market economy. Major reforms are still needed to enable it to cope over the long term with competitive pressures and market forces within the Union.

Political consensus on the essentials of economic policy has generally been maintained. Macroeconomic stability was largely maintained. Economic growth continued to be strong despite energy shortages. Monetary policy remained credible, ensuring very low inflation. The level of registered unemployment, though still high, continued to decline. Fiscal revenue performance was broadly in line with targets and budget implementation improved. Public finance reforms have further advanced but fiscal risks remain. In general, the macroeconomic policy mix was broadly adequate. Following significant delays in 2006, privatisation gained new momentum in 2007. The privately-owned banking sector is growing and generally sound. Credit expansion remained strong. The regulatory framework for banking supervision is well developed. Trade integration with the EU remained fairly high.

However, external deficits widened further, mainly due to difficulties in the energy sector. Some progress was made as regards the enforcement of court rulings and the establishment of property rights, but the shortcomings in the judicial system and law implementation affect the business climate. While company registration procedures have started to improve, administrative inefficiencies hamper market entry and exit. Some progress has been achieved in the area of supervising financial actors other than banks, but there remains
scope for strengthening it, in particular regarding the pension industry. Structural unemployment persists. Shortages of qualified staff and poor infrastructure hold back the development of a private sector that can make a sustained contribution to the country's development. The large informal sector, fuelled by persistent weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
6. BOSNIA AND HERZEGOVINA

6.1. Introduction

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

6.2. The existence of a functioning market economy

Economic policy essentials

The government submitted its first Economic and Fiscal Programme for 2006-2008 in December 2006, providing a basis for analysing prospective developments in economic and structural reform over the programme period. The programme noted the shortcomings stemming from the fact that the developments in 2006, along with the lines of policy of the incoming governments after the October 2006 elections, had not been fully captured.

Consensus has not yet been reached on the fundamentals of economic policies, reflecting the diverging views between the State level and the entities on the essentials of economic reform and coordination. The lack of consensus on implementation of reforms was manifest, in particular, in the Federation of Bosnia and Herzegovina, where the privatisation and restructuring of publicly owned enterprises has slowed down, partly as a result of the protracted process of government formation after the 2006 elections. In general, necessary reforms in areas such as labour markets, fiscal sustainability and restructuring or financial supervision have not been carried out, either at Entity or at State level. In addition, there is limited consensus on the degree of any transfer of competences to State institutions and, where it has occurred, it has often been accompanied by an increase in spending. In the area of fiscal coordination, negotiations about formalising and improving the activity of the National Fiscal Council continued, but with no tangible results. In general, a lack of coherence and consensus on economic policies prevented the acceleration of reforms at State, Entity and other government levels.

Macroeconomic stability

In 2006, real GDP growth was 6.2%, up from 4.3% in 2005, driven by domestic demand and a notable rise in net exports. Economic activity grew strongly in sectors such as wholesale and retail trade, real estate, construction, financial intermediation and manufacturing, reflecting a favourable external environment and more accurate reporting of real export values after the introduction of value-added tax (VAT). In 2006, industrial output expanded by 7.5% in the Federation and by 19.1% in the Republika Srpska, led by above-average increases in production of chemicals, metals, furniture and machinery and equipment in the former and of rubber and plastic products, metals and wood and furniture products in the latter. In the first eight months of 2007, the year-on-year increase in the volume of industrial production was 11.9% in the Federation, exceeding the modest 0.4% growth in the RS. Overall, economic growth accelerated in 2006 on the back of a more dynamic catching-up process in the RS and has remained strong in 2007, this time driven by the Federation. The shift towards higher value-added activities has been sluggish in both entities. The quality of statistical information remains rather weak.
The current account deficit almost halved to around 11% of GDP from 2005 to 2006, primarily due to a reduction of the trade deficit by around 11 percentage points of GDP. The introduction of VAT in January 2006 led to more accurate reporting of export values and a frontloading of imports in the second half of 2005. As a result, in 2006 imports were almost flat in nominal terms, while exports grew by around 29%, also helped by favourable export price developments. The favourable trend did not continue into 2007, when imports rose by about 24% year on year in the first six months, widening the trade deficit by 29%.

In 2006, the substantial trade deficit of around 35% of GDP was financed to a large extent by worker remittances in the forms of private current transfers and employee incomes which totalled around 18% of GDP on a net basis. Net FDI inflows covered only about one third of the current account deficit. In the first half of 2007, the privatisation of Telekom Srpske and a pick-up in greenfield investments boosted net FDI inflows to above 8% of the projected GDP. Due to strong capital inflows, the official foreign exchange reserves had increased by 25%, year on year, at the end of August 2007. External public debt further declined to around 21% of GDP at the end of 2006, while total external debt is estimated at around 51% of GDP. In conclusion, despite a temporary improvement in 2006, external imbalances widened again in 2007, but with increased coverage by net FDI inflows.

Employment in the formal sector increased by 1.7% year on year in June 2007. The officially registered unemployment rate increased slightly to 44.2% over the same period. The labour force survey showed a marginal increase in the employment rate to 31.2% in April 2007 from 29.7% a year earlier. While the employment rate increased to around 35% in the Republika Srpska, it remained almost flat in the Federation at about 29%. At the same time, the unemployment rate declined modestly to 29% from 31.1% over the same period and stood at around 25% in the Republika Srpska and 31% in the Federation. The still very high unemployment rate and the sizeable differences between the levels and dynamics of registered and survey-based labour data point to the existence of a fairly large and growing informal labour market and of serious structural rigidities. The reform of personal income...

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**Bosnia and Herzegovina - Main economic trends**

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<thead>
<tr>
<th></th>
<th>2002</th>
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<th>2004</th>
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<tr>
<td><strong>Gross domestic product</strong></td>
<td>Ann. % ch</td>
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<td>4.3</td>
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<td>N.A.</td>
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<tr>
<td><strong>Gross fixed capital formation</strong></td>
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<td>N.A.</td>
<td>N.A.</td>
<td>18.5</td>
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<tr>
<td><strong>Unemployment</strong></td>
<td>%</td>
<td>40.9</td>
<td>42.0</td>
<td>43.1</td>
<td>44.7</td>
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<td><strong>Employment</strong></td>
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<td><strong>Wages</strong></td>
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<td>4.3</td>
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<td><strong>Current account balance</strong></td>
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<td>-19.4</td>
<td>-16.3</td>
<td>-18.5</td>
<td>-9.9</td>
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<tr>
<td><strong>Direct investment (FDI, net)</strong></td>
<td>% of GDP</td>
<td>4.3</td>
<td>4.6</td>
<td>7.0</td>
<td>5.5</td>
<td>5.8</td>
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<td><strong>CPI</strong></td>
<td>Ann. % ch</td>
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<td>0.6</td>
<td>0.5</td>
<td>4.3</td>
<td>6.1</td>
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<td><strong>Interest rate (3 months)</strong></td>
<td>% p.a.</td>
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<td>N.A.</td>
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<tr>
<td><strong>Bond yield</strong></td>
<td>% p.a.</td>
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<td><strong>Exchange rate BAM/EUR</strong></td>
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<td>96.37</td>
<td>95.21</td>
<td>94.74</td>
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<td><strong>General government balance</strong></td>
<td>% of GDP</td>
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<td>0.7</td>
<td>1.6</td>
<td>2.4</td>
<td>2.9</td>
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<tr>
<td><strong>General government debt</strong></td>
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<td>N.A.</td>
<td>N.A.</td>
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<td><strong>Nominal eff. exchange rate</strong></td>
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<td>97.41</td>
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<td>94.74</td>
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Sources: Eurostat, Reuters/Ecowin, National sources
taxation in the Republika Srpska helped to reduce the fairly high labour tax wedge. The Federation government took steps to replicate the reform and harmonise direct taxation in the two entities.

Overall, unemployment is very high and job creation is hampered by significant structural rigidities, in particular high taxation of labour, distorted wage-setting mechanisms and low labour mobility. Relatively high and poorly targeted social transfers reduce the incentive actively to seek a job.

The monetary policy of the Central Bank of Bosnia and Herzegovina (CBBH) is conducted under a currency board arrangement with the euro as the anchor currency. The CBBH kept reserve requirements unchanged in 2006 and the first half of 2007. Annual credit growth slowed from 27.3% in 2005 to 23.4% in 2006. It bounced back to around 28.6% at the end of August 2007. The annual growth of broad money accelerated from 18.2% at the end of 2005 to 24.6% at the end of August 2007. Nonetheless, its coverage by foreign exchange reserves was ample at around 87.5% at the end of August 2007. A higher rate of inflation was recorded in 2006 on the back of the introduction of VAT and changes in administered prices. This receded significantly in 2007. The 2006 end-year consumer price index inflation stood at 6.1%. It declined to 0.9% by the end of August 2007. In conclusion, the currency board arrangement continues to underpin macroeconomic stability, despite the relatively rapid growth of domestic credit.

The replacement of sales tax by VAT in 2006 contributed to increasing consolidated government revenue to around 45% of GDP in 2006, greatly influencing the fiscal stance in 2006 and 2007. The increase in revenue by close to 4% of GDP from 2005 to 2006 resulted in increased spending at all levels of government, totalling more than 3% of GDP, and a rise in the budget surplus to 2.9% of GDP. The budget of State institutions increased by about 1.4% of GDP, due to transfers of powers from the Entities, of which 1.2% of GDP was spent on a higher wage bill. The transfer of functions to State level was not accompanied by an equivalent reduction in spending by the Entities, which also increased their expenditure as a share of GDP. Public spending increased by around 1.6% of the Entity's GDP in the Federation and by 2.9% in the Republika Srpska.

The 2007 budget execution at different levels of government shows continuing increases in public-sector wages, social transfers and welfare spending. In particular, the Law on demobilised soldiers adopted in the Federation added to aggregate social spending. Despite good revenue collection in the first half of 2007, the temporary nature of some of the high VAT revenue recorded in 2006 raises concerns that the large spending commitments in 2007 could result in a deterioration of the fiscal position. Overall, the relative consolidation of public finances in 2006 was accompanied by a slippage of expenditure which weakened the quality of the fiscal adjustment and added to the fiscal risks.

The external public debt of Bosnia and Herzegovina is on a downward trend, from around 26% of GDP at the end of 2005 to 21% at the end of 2006. However, domestic public debt is expected to raise the fiscal burden significantly in the years ahead, due to a large stock of unsettled domestic claims. The two entities further implemented the Law on the settlement of liabilities from frozen foreign currency deposits, which is expected to increase the domestic public debt significantly, in particular in the Federation. Other domestic liabilities relate to the claims for war damages. Finally, the bill on restitution, which has been sent to parliament but not yet adopted, could undermine fiscal sustainability if it fails to align financial compensation with the budget’s long-term ability to pay. The Republika Srpska adopted a Debt Law which limits government borrowing by introducing sub-ceilings on the level of debt service relative to current revenue from the preceding year. A similar law is
awaiting adoption in the Federation. In conclusion, both entities have made some progress on settling domestic claims, but the final outcome still represents a significant fiscal risk.

The improved macroeconomic policy mix from 2006, reflected in a higher surplus of the public-sector savings/investment balance and a substantial reduction of the current account deficit, was based on one-off factors that would not be repeated in 2007. The most important one was the introduction of VAT which, despite its overall positive impact, also allowed a weakening of the quality of fiscal adjustment by creating room for a large increase in public current spending. At the same time, the reform of direct taxation in the RS as of January 2007 simplified the tax system and reduced the fiscal burden, which could alleviate the distortions of the labour market in particular. In general, one-off factors helped to improve the macroeconomic policy mix in 2006, but the quality of public spending deteriorated.

**Interplay of market forces**

In 2006 and 2007, the Republika Srpska made further progress on privatisation and, after the sale of Telekom Srpske, around 63% of the initial stock of State-owned capital for privatisation has been sold. In addition, privatisation of the Republika Srpska oil businesses – Oil Refinery Brod, Oil Refinery Modrica and Petrol a.d. Banjaluka – is almost complete. The setting-up of the Investment-Development Bank of Republika Srpska for the purpose of managing the remaining State ownership, completing privatisation and investing privatisation proceeds via various funds, is intended to improve allocation of public resources, but at the same time threatens to crowd out private-sector activities, in particular in the banking sector. Similarly, adoption of the development programme of Republika Srpska – which plans to invest a large share of the funds in industrial activities, corporate restructuring and housing construction – could run counter to the initial objective of divesting State ownership.

In 2006 the private sector’s country-wide share in GDP remained around the 55% level recorded in 2005. The main reason for this was the slowdown of the privatisation process, which affected the Federation most. In 2006, the various privatisation agencies in the Federation (Entity and cantonal) sold stakes in 14 companies, with the total capital privatised worth €86 million and investment commitments of around €87 million. This equals only about 2% of the total State-owned capital slated for privatisation in 1999, bringing the cumulative percentage of capital privatised so far in the Federation to around 41%, of which only about one quarter was privatised by direct tendering. Cash proceeds from these privatisations in 2006 totalled some €12 million. In 2007, the Federation Privatisation Agency plans to privatise another 3% of the initial stock of State-owned capital, either by direct tendering or by stock-exchange sales, and to restructure a further 3% of that stock prior to privatisation. However, the process came to a standstill, as tenders for some strategic companies (e.g. Energoinvest and Hidrogradnja) were cancelled and privatisation of Aluminij d.d. Mostar was delayed, diminishing the prospects for faster privatisation in 2007. What is more, the situation in late August was that the privatisation process, except for the ongoing sales, had been put on hold by the Federation cabinet until a general privatisation policy is formulated.

**Free market entry and exit**

Implementation of a single business registration system started in a limited number of courts in June 2007. It should shorten the procedure for court registration to five days and reduce the number of documents required. Survey data suggest that up to June 2007 no particular progress was made on the procedures for starting a business, obtaining licences or
closing a business. However, some progress was made on reducing the number of inspections faced by companies in both the Federation and the Republika Srpska. Furthermore, the RS authorities are close to completing a regulatory impact analysis aimed at reducing red tape, known as the "guillotine process". Bankruptcy procedures have been improved and the number of cases initiated and closed by the courts has gradually increased. Less progress has been achieved on applying bankruptcy procedures to the high number of insolvent publicly owned companies, as suggested by the large and increasing amount of state aid and public-sector subsidies. Major obstacles to business entry persist in areas such as obtaining licences, registering property, enforcing contracts and paying taxes. Overall, company registration and licensing procedures have improved marginally, but significant administrative inefficiencies are continuing to hamper market entry and exit and making it difficult to do business.

The legal system

The judicial system continues to suffer from slow court proceedings, poor case management and a large and growing backlog of unresolved cases. Political interference in the system has occasionally occurred. Overall, these circumstances impair the business environment by undermining effective enforcement of creditor and property rights.

Development of the financial sector

Banks hold a dominant position in the financial sector and their assets grew to around 82% of GDP in 2006, up from 76% in 2005. There were 32 banks operating at the end of 2006 (compared with 55 in 2000), with foreign capital controlling about 83% of the total bank capital. Privatisation of banks was completed in 2006 in the Republika Srpska. In the Federation three banks remain in public hands, all under provisional administration. The five largest banks held around 59% of the total assets of the banking system at the end of 2006, similar to 2005. This, along with the narrowing of interest spreads, shows that bank consolidation is not hindering market competition.

Non-bank financial sectors recorded sustained growth in 2006. The leasing market grew by around 30% to 2.4% of GDP at the end of the year. The insurance sector is fragmented and obstacles remain for the operation of insurance companies of one Entity in the other one. The sector's assets are estimated at about 3.2% of GDP. Loans in the micro-credit sector totalled 2.5% of GDP. New harmonised Entity-level laws were adopted on micro-credit institutions along with amendments to the laws on banking supervision agencies in order to bring the micro-credit sector under the scope of banking supervision agencies. In 2006, the market capitalisation of the Sarajevo Stock Exchange increased by 76% and ended on almost 95% of GDP in the Federation, while the Banja Luka Stock Exchange increased its capitalisation by 175% to more than 121% of GDP in the Republika Srpska. Overall, at the end of 2006 stock market capitalisation of both exchanges in Bosnia and Herzegovina stood at 108% of the country's total GDP. In conclusion, the financial sector is developing rapidly.

Financial stability indicators point to a strengthening of the banking system in 2006. The ratio of non-performing loans to total loans decreased to 4% at the end of the year. Although marginally lower than a year earlier, the capital adequacy ratio was relatively high on 17.7% at the end of 2006. Over the same period, average return on equity increased by 2.3 percentage points to 8.5%, suggesting improving profitability. A single credit registry was established for legal entities in 2006 and extended to physical entities in early 2007. However, banking supervision is conducted by two separate Entity agencies under the weak coordination of the CBBH and thus remains fragmented. The rapidly growing leasing operations have not yet been included in any supervision framework, although in the
Republika Srpska newly adopted legislation brought leasing operations within the scope of banking supervision. Overall, supervision of the financial sector has not been adequately strengthened.

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

Existence of a functioning market economy

Macroeconomic stability has improved. Economic operators are able to take decisions in a climate of relative stability and predictability, despite risks related to a deterioration of fiscal and external balances. The slowdown of structural reforms, in particular in the Federation, together with the lack of consensus on economic policies and the continuing strong influence of the public sector in the economy, still hinder efficient allocation of resources by market mechanisms.

Human and physical capital

The Higher Education Law has been adopted. A package of other education laws, including one on vocational training, is still awaiting adoption. Efforts have been made to improve the quality of vocational training and to establish a closer link with the needs of the labour market. Despite some improvement, enrolment rates for secondary and higher education and graduation rates remain relatively low. According to the labour force survey, participation in the labour market is still very poor, as indicated by an activity rate of around 44% and an unemployment rate which declined marginally to 29% in April 2007. The authorities are taking a number of active labour market measures to alleviate the current situation, but without much success. Improved performance on the labour market depends heavily on reducing labour market rigidities and increasing labour mobility. Overall, the reform of the education system has been progressing only slowly and the low education outcomes do not justify the relatively large number of initiatives and public spending in this area. The weak performance of the labour market requires strong structural adjustments.

In 2006, as in the previous year, FDI went predominantly to the financial sector, but the manufacturing sector also attracted about a quarter of the inflows. Investment totalled around 21% of GDP in 2005. FDI inflows into Bosnia and Herzegovina increased moderately, from 5.5% of GDP in 2005 to 5.8% in 2006, bringing the total stock of FDI per capita to a relatively low € 780. However, so far in 2007 FDI inflows have risen sharply, taking the FDI stock per capita to over €1,000 euros. Upgrading of the telecommunications and transport infrastructure has continued, particularly of local road construction. Development of the R&D sector is hindered by obsolete research infrastructure, weak performance of higher education and a massive brain drain of scientists. To conclude, the upgrading of physical capital is progressing, but in a low gear.

Sector and enterprise structure

Legal frameworks that would allow financial restructuring and debt write-offs for State-owned enterprises were put in place in both entities in 2006. In addition, the privatisation legislation was amended in the Federation to allow, inter alia, the splitting-up of State-owned enterprises into viable components that would be subsequently sold, although so far it has had no tangible impact on the volume of privatisation. The new legislation on financial restructuring in the Republika Srpska has produced some positive results, facilitating the sale of the oil-refining companies.
In the Federation, the rescheduling and writing-off of state-owned companies’ accumulated budget arrears allowed outside the restructuring/privatisation process can have damaging effects on corporate governance in the long run. In addition, the plans to restructure the energy sector by including profitable and non-profitable units in joint entities diminish the long-term viability of the sector. Overall, the restructuring of state-owned enterprises is progressing fairly slowly and is hindered by the vested interests of enterprise managers, trade unions and decision-makers.

The liberalisation of network industries has continued, with mixed results. Some progress has been made with the preparations for opening up the electricity market, but less in the gas sector. Unbundling of distribution and generation in the energy sector is proceeding slowly. Some progress has been made with liberalisation of the telecommunications sector, in particular in the form of privatisation of Telecom Srpske. Structural separation of the railway companies has yet to be completed in the two entities and these companies are still loss-making. To conclude, only limited progress has been achieved on liberalisation of the network industries.

The gradual shift in the sectoral structure of the economy towards services – retail and wholesale trade, financial intermediation and real estate – is continuing. At the same time, the structure of exports and industrial production reveals a shift towards higher value-added goods. This trend is more marked in the Federation and, overall, is proceeding at a slow pace.

The small and medium-sized enterprises (SME) sector is growing, but has to cope with a difficult business environment. Access to longer-term financing and the lack of collateral remain problematic. Progress has been achieved at Entity level, but there is no consensus on establishing a support framework for SMEs at State level, which would help the country to comply with the European Charter for Small and Medium-Sized Enterprises. The Federation adopted a law to promote the development of SMEs. The Republika Srpska National Assembly approved a strategy for the development of SMEs for 2006-2010. To sum up, some progress has been made at Entity level on setting up structures to support SMEs, although uncoordinated in terms of a country-wide strategy.

**State influence on competitiveness**

Some progress has been made on enhancing transparency on State aid by compiling a preliminary state aid inventory for 2004-2006. The majority of Bosnia and Herzegovina's support programmes would not qualify as state aid schemes, given that they usually last less than a year or are even adopted on an ad hoc basis. The amounts granted are large and increasing and varied, on average, from 1.7% to 4.5% of GDP over the period, depending on the estimation method. A large proportion of the support goes to sectors such as public transport and utilities, agriculture and mining. State intervention in the productive sector remains significant. The Competition Council increased its activity on carrying out investigations and issuing decisions. Sustained efforts are now necessary to achieve more effective anti-trust control.

**Economic integration with the EU**

Bosnia and Herzegovina is an open economy with total trade equivalent to around 103% of GDP in 2006. This share went down slightly from about 108% of GDP in 2005, mainly due to the frontloading of imports prior to the introduction of VAT. In 2006, the EU continued to be the most important trading partner with shares of around 69.4% of Bosnia and Herzegovina's total exports and of 60.2% of its total imports. FDI inflows from the EU
declined temporarily in the first half of 2007, following the large sale of Telecom Srpske to a non-EU company. Overall, integration of trade and investment with the EU remains strong.

The consumer price indexed-based real effective exchange rate calculated in relation to 20 trading partners appreciated by around 4.2%, year on year, by the end of June 2007. In the first six months of 2007 it appreciated moderately (by around 2.1%) compared with the 2003 level. In 2006, the unit labour cost-based real exchange rate against the euro appreciated by around 2%, despite an increase in labour productivity of about 4%. Consequently, price competitiveness was largely preserved.

The per capita income of Bosnia and Herzegovina, measured in purchasing power standards (PPS), was around 29% of the EU-27 average in 2006, slightly up on 2005.

6.4. Conclusions

Bosnia and Herzegovina’s economy has continued to expand rapidly. Overall macroeconomic stability has been maintained, but threats to fiscal sustainability persist. The persistence of very high unemployment remains a major cause of concern. The deterioration of the overall political climate in the country was reflected in a slow-down in structural reform and in the business environment. Country-wide economic integration across entities has still to be fully achieved.

As regards economic criteria, Bosnia and Herzegovina has made little progress towards establishing a functioning market economy. Major reforms are needed to enable it to cope over the long term with competitive pressure and market forces within the Union.

Economic growth remained high and accelerated, while the external balance improved markedly in 2006. The currency board arrangement continued to underpin macroeconomic stability and inflation receded to the low levels recorded before the introduction of the VAT in January 2006. The introduction of VAT has increased fiscal revenue in 2006. The Federation took steps to replicate the January 2007 reform of direct taxation in the Republika Srpska, which simplified the tax system and reduced the fiscal burden. Privatisation progressed in Republika Srpska, led by major sales in the telecommunication and oil sectors. Foreign direct investment (FDI) increased significantly in 2007 and helped finance the external deficit. The financial sector developed rapidly while price competitiveness was to a large extent preserved.

However, the overall political climate and weak domestic consensus on the fundamentals of economic policy led to a slow-down of reforms both at entity and other levels of government. The lack of coherence and consensus in the implementation of reforms was manifest in particular in the Federation where the privatisation and restructuring of publicly-owned enterprises slowed down. Despite robust economic growth, unemployment remains very high. Public spending, and in particular social spending, rose significantly, weakening the quality of fiscal adjustment and adding to fiscal risks. Significant structural rigidities hamper the functioning of the labour market. The restructuring of state-owned enterprises advanced slowly and progress in the liberalisation of network industries was limited. The business environment is still affected by significant administrative inefficiencies, weak enforcement of creditor and property rights and sizeable intervention of the state in the productive sector. The large informal sector, fuelled by weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
7. MONTENEGRO

7.1. Introduction

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

7.2. The existence of a functioning market economy

Economic policy essentials

The government submitted its first Economic and Fiscal Programme (EFP) 2007-2008 in December 2006. This programme sets out a conservative macroeconomic scenario in which the aim of the fiscal framework is to consolidate the fiscal stance and reduce public debt. In January 2007, Montenegro became a member of the International Monetary Fund (IMF) and the World Bank (WB). Eventually, the Montenegrin authorities decided not to conclude a stand-by arrangement with the IMF. The World Bank adopted a new Country Partnership Strategy focused on reforming the labour market, improving living standards and strengthening administrative capacity.

The consensus on economic policy was challenged by the so-called "January electric shock", when expensive imports of electricity led to households' electricity bills rising to 35% of the average monthly salary. These developments, and the discussion within the government on a comprehensive energy strategy, delayed the decisions of the government on the overall privatisation process.

Macroeconomic stability

GDP grew by 6.5% year on year in 2006. The main drivers were the strong expansion in tourism and construction, helped by massive FDI inflows and rising levels of bank lending. This trend continued in the first half of 2007, when the year-on-year growth in GDP was 6.9%. Once again the main driver was the robust expansion of the services sector, in particular tourism, financial intermediation and real estate. Industrial production rose by only 1% in 2006, and in the first eight months of 2007 it recorded a further year-on-year fall of 4.4%. Output shrank, mainly as a consequence of the halt of the thermal power plant for maintenance repairs and the stoppage of the associated coalmine. Moreover, severe drought hampered the production of the two main hydropower plants. Overall, economic growth remained strong, but became increasingly exposed to a possible correction of mounting imbalances.

In 2006 the current account deficit widened to 26% of GDP, driven by the large increase in imports of goods triggered by strong domestic consumption and investment. The solid performance of the tourism sector only partially succeeded in offsetting the widening of the trade deficit and the fall in net current transfers. The balance of net factor income reported a solid increase, but still remained modest. However, foreign exchange reserves had increased by 80% at the year's end to reach 16% of GDP. The current account deficit was financed by very strong inflows of net foreign direct investment (FDI) of 23.7% of GDP. The current account deficit widened further during the first half of 2007 to 31% of GDP in annualised terms, driven by the growing trade deficit. Exports of goods barely covered one third of
imports, which grew faster. The balances on services, income and current transfers were all positive, but insufficient to offset the negative impact of the huge trade deficit. In the same period, net FDI increased rapidly to reach 28.4% of GDP in annualised terms, and was accompanied by a surge in portfolio investments. Moreover, net foreign assets of commercial banks almost doubled in the first half of the year. Overall, the large external imbalances are being covered by foreign investments and increasing foreign exchange reserves.

Montenegro - Main economic trends

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<tr>
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<th>2002</th>
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<th>2004</th>
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<th>2006</th>
<th>2007</th>
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<tr>
<td>Gross domestic product</td>
<td>Ann. % ch</td>
<td>1.7</td>
<td>2.4</td>
<td>4.2</td>
<td>4.0</td>
<td>6.5</td>
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<tr>
<td>Private consumption</td>
<td>Ann. % ch</td>
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<td>:</td>
<td>:</td>
<td>:</td>
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<tr>
<td>Gross fixed capital formation</td>
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<td>-16.1</td>
<td>:</td>
<td>:</td>
<td>:</td>
<td>:</td>
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<tr>
<td>Unemployment</td>
<td>%</td>
<td>28.9</td>
<td>26.0</td>
<td>22.3</td>
<td>18.5</td>
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<td>Employment</td>
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<td>Wages</td>
<td>Ann. % ch</td>
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<td>Current account balance</td>
<td>% of GDP</td>
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<td>-7.2</td>
<td>-8.9</td>
<td>-26.0</td>
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<tr>
<td>Direct investment (FDI, net)</td>
<td>% of GDP</td>
<td>6.9</td>
<td>2.8</td>
<td>3.1</td>
<td>22.0</td>
<td>23.7</td>
</tr>
<tr>
<td>CPI</td>
<td>Ann. % ch</td>
<td>16.4</td>
<td>6.8</td>
<td>2.2</td>
<td>2.4</td>
<td>3.0</td>
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<tr>
<td>Interest rate (3 months)</td>
<td>% p.a.</td>
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<td>1.21</td>
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<td>Bond yield</td>
<td>% p.a.</td>
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<td>3.1</td>
<td>1.2</td>
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<td>Exchange rate EUR/EUR</td>
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<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
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<tr>
<td>Nominal eff. exchange rate</td>
<td>Index</td>
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<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td>General government balance</td>
<td>% of GDP</td>
<td>N.A.</td>
<td>-1.9</td>
<td>-2.4</td>
<td>-2.7</td>
<td>1.1</td>
</tr>
<tr>
<td>General government debt</td>
<td>% of GDP</td>
<td>88.3</td>
<td>51.1</td>
<td>44.9</td>
<td>40.4</td>
<td>35.6</td>
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Sources: Eurostat, Reuters/Ecowin, National sources

The officially registered unemployment rate was down to 14.7% at the end of 2006, and fell further to 11.8% by end-August 2007. Employment grew by 3.8% in 2006, and continued expanding in July 2007 at a year-on-year rate of 4.2%. The biggest increases in employment are being recorded in services, particularly in the retail and wholesale trade. The fall in the number of local employees in the most dynamic sectors, namely tourism and construction, was offset by the rising numbers of non-resident employees, mainly coming from neighbouring countries. Overall, the growth in economic activity is having a positive effect on the labour market.

The country unilaterally uses the euro as legal tender, an issue which is completely separate from membership of the euro area. Consequently, it does not conduct any monetary policy, does not participate in the joint management of the single currency, including notably monetary policy, and does not enjoy the rights of a euro area Member State. The central bank is not an issuing bank, and most of its executive functions are related to banking supervision. It also engages in liquidity management operations for the banking sector and issues treasury bills on behalf of the government.

In October 2007 the Council adopted a declaration on the de facto use of the euro in Montenegro which is due to exceptional circumstances. The conditions for adoption of the euro and join the euro area are defined by EU law.
Annual broad money growth\textsuperscript{13} accelerated in 2006 by 85\% year on year. At the end of July 2007, the money supply had increased by 47.8\% since the beginning of the year. At the end of 2006, total assets of commercial banks were up by 104.8\% year on year representing 72.6\% of GDP. The main factor in this strong expansion was the rapid growth of almost 125\% year-on-year in the credit portfolio, with household lending surging by 198\% and corporate loans by around 102.3\%. Bank deposits also expanded strongly (119.6\% year on year).

However, during 2007, the average monthly growth rate of deposits (6.8\%) has been lower than that of loans (9.5\%), and foreign borrowing is rapidly supplanting deposit growth. Total assets of commercial banks reached 106.7\% of GDP in July, of which, deposits amounted to 78.9\% of GDP. In the first seven months of the year, loans increased by 88.6\% and accounted for 74.2\% of GDP, compared to 25.2\% of GDP a year earlier. In July, loans to enterprises accounted for 59.2\% of total lending, while households and the government sector accounted for 36.2\% and 2.9\% respectively. Despite a fall in interest rates on lending, they remain relatively high. The average weighted nominal lending interest rate stood at 8.24\% at end July. In general, the surge in consumer loans is becoming a matter of concern which needs to be closely monitored by the Central Bank.

Average annual consumer price inflation rose from 2.3\% in 2005 to 3\% in 2006, dropping back to 2.8\% on average between January and August 2007. The major factor behind this deceleration is the steady fall in the price of food since the beginning of the year. Prices of all other goods and services have remained relatively stable during the same period, although the prices went up during summer, mainly due to international price increases, but also due to higher domestic food and electricity prices. Overall, the low inflation environment is helping the positive performance of the economy.

The consolidated budget for 2006 revealed a surplus of 1.1\% of GDP (cash-based accounting standard). The better-than-expected fiscal performance was the result of solid growth of revenues, outpacing the growth of public expenditure. Strong economic performance led to continued surpluses in the first half of 2007, despite the introduction of a reduced flat rate of 15\% for personal income tax at the beginning of the year. Revenue growth accelerated strongly to reach 36.7\% year on year. The strong performance of the economy and robust import growth explained the higher than planned VAT receipts. Additionally, the proceeds from corporate income tax significantly exceeded their target, reflecting the improved performance of the real sector. By contrast, total government spending grew more slowly, at a rate of 11.2\% year-on-year, despite the increase in spending on gross wages and transfers to state funds and local self-government. However capital spending was still substantially below target (38\%). Overall, fiscal consolidation continued on the back of solid revenue growth.

In 2006, public debt fell to 35.6\% of GDP at year-end. However, the share of domestic debt has been rising, driven by the settlement of restitution claims and compounded by the rapid growth in real estate prices. In the first half of 2007, public debt remained at the same level after increasing to 36.9\% of GDP at the end of the first quarter. Domestic debt, which represents one third of the total, grew by 17.6\% in the same period. In July 2007, the Parliament adopted amendments to the Law on restitution, limiting the annual payments for this concept to 0.5\% of the previous year's GDP. However, the law may still be revoked by the Constitutional Court.

\textsuperscript{13} Broad money (M21) aggregate comprises banks' deposits with the CBM, the estimated amount of cash in circulation, demand deposits and term deposits by the non-banking sector including, central government's.
Substantial progress has been achieved in enhancing the transparency and accountability of public sector governance. A new Law on public procurement was adopted in 2006 aimed at harmonising legislation with the EU acquis and strengthening procurement procedures and practices. Internal and external audit functions are being implemented; however, owing to administrative capacity constraints, neither of them is fully operational and effective. The gradual separation of current and capital expenditures was further pursued in the 2007 budget exercise, which extended the coverage of investment projects by the capital budget. Moreover, in July, the government adopted the bill on amendments to the budget law, which will further consolidate public expenditure by integrating former extra-budgetary funds within the treasury system.

However, budget planning is still hampered by weaknesses in forecasting government revenues and expenditures. Also, the implementation of programme budgeting in line ministries and the development of a medium-term fiscal framework have not yet been finalised. Local governments have significant extra-budgetary activities and arrears which are currently not accounted for clearly in the consolidated budgetary framework. The quasi-fiscal activities of state-owned enterprises are fairly substantial and include debts and arrears to the government, company debts covered by state guarantees, intra-company transfers and some tax subsidies. As these contingent liabilities are not yet included in general government reporting, there is a risk that they easily become a fiscal burden on the budget. This has made it all the more urgent for there to be careful supervision of the financial operations and the issuing of debt by local government, and of state-owned enterprises.

The policy mix is determined by euroisation and the absence of a proper monetary and exchange rate policy. The authorities are committed to continuing the consolidation of fiscal policy. The good performance of revenues provides the necessary fiscal space to push ahead with tax and labour market reforms.

**Interplay of market forces**

About 86% of the original social and state owned capital has been privatised. However, the privatisation process has slowed down since the September 2006 elections. The appointment of the Privatisation Council, the government decision on the privatisation of the thermal power plant and the adoption of the Energy Development Strategy were delayed. A new privatisation programme was finally adopted in July 2007. It contains a list of 58 companies to be privatised. Some of the major state-owned companies listed are Montenegro Airlines, the port of Bar, the railways company, the shipyard Bijela, the tobacco producer Duvanski Kombinat, and the tourism resorts HTP Ulcinjska Rivijera and HTP Budvanska Rivijera. However, a few companies that were initially included in the draft plan will not be privatised, at least not in 2007 (the power utility EPCG –excepting its distribution sector–, Montenegrin airports, wine producer Plantaže, and the national post company). The privatisation process has been put on track again with the publication in October 2007 of the tender for shipyard Jadran. The Parliament has appointed a commission to monitor the transparency of privatisation procedures. Meanwhile, the share of employment in the public sector has increased, partly due to new responsibilities arising from sovereignty and the EU integration process. Overall, state intervention and ownership remain limited.

**Market entry and exit**

The establishment of new firms is facilitated by the limited number of requirements on founding capital, registration time and costs. The number of established companies rose by 17% in 2006, and by 10% in the first half of 2007. The cost, in both time and money terms,
of obtaining a licence to run a business is still the major constraint on firms. In October 2007 the government adopted a programme for the elimination of barriers for the development of enterprises. Moreover, there are still some outstanding difficulties concerning bankruptcy cases. To improve the situation, a new law amending the Law on Company Insolvency was adopted in 2007. This new law, which is much easier to implement, simplifies the conditions required to file for bankruptcy and sets a limit (EUR 25,000) on compensation by the bankruptcy administrator. Overall, further progress is needed to facilitate the procurement of business licences.

**Legal system**

In June 2007 the new law on land surveying and cadastre entered into force. This law guarantees equal rights to national and foreign citizens. It further facilitates registration of property and transparency, including a new cadastre online service reporting on property status. However, further progress is still needed to make it easier to enforce commercial contracts. It still takes up to 18 months for a company to collect its debt, and the cost is 15% of the debt. These circumstances may discourage economic actors from taking cases to court and undermine the effective enforcement of creditors' rights and property rights.

**Financial sector development**

Driven by the completion of the privatisation process in 2006, the banking sector has continued to expand rapidly. The ownership structure at the end of 2006 was 80% foreign capital, 15.4% domestic capital and 4.6% state capital. The degree of concentration in the banking sector is moderate, with the assets of the five biggest banks accounting for 80% of the total assets of the sector. In the first half of 2007, total domestic credit growth rose by 77.3% to reach 69.7% of GDP. Increasing competition between commercial banks is resulting in lower lending interest rates. In June, the average weighted effective interest rate fell slightly to 9.1%, and deposit interest rates to 5%. The surge in domestic credit, and particularly in consumer lending, exacerbated the credit risk in the banking system (a deterioration of asset quality and an increase in non-performing loans). Further strengthening of banking supervision is hampered by the delay in the adoption of the new banking law. Overall, financial intermediation continued to expand strongly.

Capital markets saw very strong growth. In 2006, the total turnover of the two stock exchanges amounted to 19% of GDP, while market capitalisation represented 100.7% of GDP. These very dynamic developments continued in 2007, driven by strong interest from both foreign and domestic investors. Furthermore, the abolition of capital gains tax and the adoption of the legislative framework on voluntary pension funds in 2007 gave additional impetus to the stock markets. In June, a commercial bank placed a bond issue for the first time. In August, a second voluntary pension fund was established. However, since May 2007 stock markets have witnessed a moderate correction for three consecutive months. Overall, despite its dynamic development, the role of the capital markets remains limited.

In 2006, insurance market premiums rose by 18% and accounted for 2.1% of GDP. Although there are six insurance companies in the country, one of them maintains a dominant market share (70%). The sector is dominated by car insurance, while the life segment, which is less developed, accounts for less than 5% of billed premiums. An insurance law, establishing an independent supervisory agency, was adopted at the end of 2006. The government passed the law on receivership and liquidation of insurance companies in June 2007, thus completing the legal framework of the sector. The proposed legislation defines the terms of and procedures for receivership, voluntary and judicial liquidation of insurance companies and the rights and liabilities of parties to these
proceedings. In addition, three insurance companies have re-established a mutual guarantee fund (absent since the dissolution of the state union with Serbia). In 2007, the sector expanded further with the entry of two new firms, including the first life insurance company.

Since the adoption of the law on financial leasing in 2005 this market has been growing. By the end of June 2007, four companies and three banks were providing leasing services accounting for 3.7% of GDP. Most of the leasing contracts are related to business activities, in particular for the purchase of vehicles. Overall, non-banking supervision remains incomplete in that leasing companies are not yet covered.

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

Existence of a functioning market economy

Generally, macroeconomic stability has been maintained. However, there remain some risks to macroeconomic stability in the medium term, such as the large external deficit and the surge in consumer loans. The functioning of the market mechanism has lately been strengthened in particular by the continuing relatively low level of inflation and the reduction of the fiscal burden, whereas the pace of structural reforms has been slowing.

Human and physical capital

The government continues ahead with the reform programme to improve vocational and technical education, update teacher training and link pay to performance. At 5% of GDP, expenditure on education is fairly significant with some 80% of it going on current expenditures. The aim of the reform programme is to allocate a biggest share to infrastructure and the provision of computers and textbooks. Enrolment rates are very high – up to 96% in primary schools and between 85 and 90% in secondary schools. However, 75% of secondary students are enrolled in vocational or technical programmes which, for the most part, do not match the needs of future employers.

Despite falling unemployment and rising employment levels, the labour market continues to face significant challenges. The main reasons are the structural character of unemployment, the strong seasonal pattern of employment (construction, agriculture and tourism) and the significant impact of the informal sector. The current legal framework provides for high dismissal costs, low wage flexibility and a fairly high tax rates on labour. Consequently, the rate of participation is low (51%), unemployment among young people is high (20.1%), and a significant proportion (58.2%) of job seekers are long-term unemployed. With a view to raising participation and employment rates, the authorities are investing around 1% of GDP in active employment measures, which were responsible for the creation of some 20,000 new jobs in 2006 (or 7.6% of the labour force). However, there are no significant measures to increase labour market flexibility. Moreover, the regulations governing temporary contracts are even stricter than for permanent contracts. Overall, improvement of labour market flexibility remains the most important task to be addressed.

The surge in domestic credit to private enterprises is an indication of an increase in investment. Net inflows of foreign direct investment (FDI) continued their strong growth. Net FDI on an annual basis reached 24.2% of GDP in 2006, and 28.4% by the end of June 2007. The real estate sector accounts for half of FDI inflows, reflecting the strong performance of the construction sector (178% in 2006). A Council for Scientific Research has been established which is expected to facilitate future investments in research and
development. Overall, the economy is benefiting from strong and increasing levels of investment.

**Sector and enterprise structure**

The reform of the energy sector remains the key issue in the reform of state-owned enterprises, and not only because of the sheer size of the sector. Electricity demand is growing fast, while production is hampered by outdated structures and the urgent need for capital investment. From July 2007, the regulator has introduced a new tariff system, reflecting the relative shares of transmission, distribution and supply fees. The 2007 increases in the price of electricity by an average of 9% are not sufficient to cover production costs. The new tariffs are contested by the generator and consumers. The government intervened by adopting a programme of subsidies to be paid through the Ministry of Health, Labour and Social Welfare, in the form of direct subsidies to low-income households to cover 30% of their electricity bill, and thereby avoid price distortions.

The completed unbundling of electricity distribution, in accordance with the Energy Community Treaty signed by Montenegro, makes it easier for new players to enter the local market. In September 2007, Balkan Energy - a Greek-owned company - acquired the Berane lignite mine and committed investments to build a 110Megawatt power plant. The discussion on a comprehensive energy strategy delayed the decisions of the government on the privatisation process. Overall, the Energy Development Strategy needs to be implemented without further delay.

The liberalisation of the telecommunication market is complete. The sector accounted for 13% of GDP in 2006. Despite full liberalisation, there is practically no competition in the fixed-line market. However, the mobile phone market, although saturated (teledensity exceeding 100%), remains extremely competitive. A third mobile operator began operating in July 2007, and new wireless and 3G services have also been introduced. The share of internet users (23.9%) is increasing but more slowly. However, although the country has five internet service providers, some parts of the population still do not have access to modern telecommunication services.

Preparations are being made for restructuring the railways and the port of Bar. In both cases, the government is maintaining ownership of the infrastructure, while offering concessions to the railway and port operators.

The sectoral evolution in the economy continues to be characterised by further consolidation of the services sector as the main pillar of the economy. The shares of employment in agriculture and industry continued their downward trend in 2006, representing 4.5% and 26% of the total labour force while, in the same period, services - in which 70% of the total labour force is employed - increased their share by 7%. Overall, the consolidation of a service economy continues.

In 2006, the number of small and medium-sized enterprises (SMEs) rose by 3.8% and accounted for half of the GDP, but their share of the total number of registered companies fell slightly. Employment in SMEs grew by 2.1% year on year, accounting for 35.6% of the labour force in 2006. Credit to firms is expanding very rapidly, doubling in 2006 and practically doubling again in the first half of 2007, despite high interest rates and the fact that commercial banks do not yet have access to the credit register of the Central Bank. Companies have the option of paying their taxes electronically. However, this facility is not yet available for payment of VAT on imports, as the Customs Office still requires presentation of proof of payment. A first business incubator was established in 2007. In October 2007 the government adopted a mid-term strategy for development of the SME
sector. Overall, the performance of SMEs has moderately improved, but some administrative procedures still hamper the business environment.

**State influence on competitiveness**

Subsidies doubled in 2006 compared with the previous year and accounted for 0.7% of GDP. Moreover, other subsidies in kind have been granted for limited periods to privatised enterprises, to help them with their reform process. Subsidisation of electricity prices to the aluminium and steel mill companies is one example of this. In the case of indebted companies awaiting privatisation, it is not uncommon for the government to make debt-to-equity swaps to increase the proportion of state ownership, thus making the share to be privatised more attractive to potential investors. However, during privatisation negotiations, bidders can obtain additional advantages such as a corporate profit tax break, or a concession for custom duties and VAT on imported machinery and equipment.

Following the exceptional drought of 2007, the government adopted temporary measures to help the agricultural sector. The consequences of the negative impact, which the government estimated at some EUR 10 million, will be mitigated by the reduction in the VAT rate – for a period of one year - on some basic agri-products, an increase in the price paid by the state to purchase milk and tobacco, the reduction of tariffs on meat imports, tax relief on agricultural land and the supply of cereals and sugar by the state to avoid rises in the price of the end-products. Overall, state intervention in the productive sector remained limited to post-privatisation arrangements and agriculture.

**Economic integration with the EU**

Montenegro is an open economy. In 2006, exports and imports of goods and services as a percentage of GDP rose to 49.1% and 84.7% respectively. Tourism remains the main source of export revenue; despite current infrastructure shortages, the sector accounted for 17% of GDP in 2006. The main manufactured product (aluminium) accounts for 11% of GDP and 40% of exports in value terms. The EU remains Montenegro's main trading partner. Trade with Serbia also remains significant, accounting for 32.7% of total exports and 28.2% of imports. However, the proportion of import and export trade with Serbia is decreasing with time. Total foreign direct investments in 2006 represented 33.4% of GDP. The EU accounted for the overwhelming part of total inflows. Others include Russia with 3.7%. Overall, the level of economic integration with the EU is fairly high, although dependent on the performance of a few markets.

However, the structure of the external sector has been adversely affected by the strength of the euro, in particular as regards trade with Serbia and exports of aluminium. Trends in wages and labour costs also show how the price competitiveness of the economy has been eroded. In 2006, unit labour costs increased by 18.3% as the average net wage rose by 12% in real terms (well above the 2.6% growth in labour productivity growth). Overall, increasing labour costs and the recent rise of the euro have affected the country's competitiveness.

**7.4. Conclusions**

Montenegro’s economy has continued to expand rapidly and macroeconomic stability has improved, though risks subsist, in particular from the large current account deficit, at present largely compensated by important FDI inflows. Though structural reforms were
pursued, weak institutional capacities and deficiencies in the rule of law continue to hamper
the proper functioning of the market economy.

As regards economic criteria, Montenegro has made further progress towards establishing
a functioning market economy, though at a slower pace. Major reforms are needed to enable
it to cope over the long term with competitive pressure and market forces within the Union.

Macroeconomic stability overall improved. The rapid economic growth helped create jobs
while inflation remained subdued. Large inflows of foreign investment supported economic
activity. A prudent fiscal consolidation policy stance was pursued, resulting in a continued
budget surplus. The reform of the pension system continued. There was a rapid growth in
the activities of financial intermediaries. New mechanisms to enhance the transparency of
the privatisation process have been established. New legislation on company insolvency
facilitated market exit. Subsidies remained limited to some post privatisation arrangements.
Reform of the utilities continued. Trade openness and the alignment process with WTO
rules supported further economic integration with the EU.

However, there are some risks to macroeconomic stability, in particular from the large
external deficit. Energy price increases led to a debate within the country, including within
the government, about the Montenegrin energy policy and the planned privatisation of
energy suppliers. Growth of industrial production has been very modest. It is still expensive
and time-consuming to obtain business licenses and enforce contracts. More needs to be
done to improve the financial services sector, including revision and implementation of the
banking law, the establishment of an insurance supervisory agency and supervision of
leasing companies. Moreover, the very high growth of consumer credit and of asset prices
signal widening macroeconomic and financial imbalances. Though unemployment declined,
it remained high. At the same time, increasing labour costs continued to erode the country's
competitiveness. The large informal sector, fuelled by persistent weaknesses in law
enforcement and the regulatory framework, reduces the tax base, hampers the government's
capacity to implement economic policies and affects negatively the business environment.
8. SERBIA

8.1. Introduction

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

8.2. The existence of a functioning market economy

Economic policy essentials

In December 2006 the government submitted to the European Commission its first economic and fiscal programme (EFP), covering 2007-2008. It builds on the budget memorandum of April 2006 and presents a generally coherent macroeconomic and fiscal framework together with an ambitious agenda for structural reforms. If implemented in full, the EFP will contribute to sustainable growth and real convergence. The government adopted the 2007 budget memorandum in June. No new cooperation with the International Monetary Fund (IMF) has been sought after the previous arrangement expired in February 2006. The government has cited the need for greater ownership of and autonomy for economic policy planning and implementation. Cooperation with the World Bank has remained a firm anchor for structural reforms. Overall, consensus on the fundamentals of a market economy has been maintained, but some dissent between different institutions has been growing in regard to stability-oriented fiscal policy targets.

Macroeconomic stability

In 2006, real GDP growth slowed down to 5.7% compared with 6.2% a year earlier. Growth was driven by strong gains in transport, storage and communication, but also in the financial sector and in wholesale and retail trade. In the first half of 2007, GDP grew strongly by 8.0% year-on a year-on-year basis, driven by continuing strong gains in wholesale and retail trade, transport, finance and manufacturing. Industrial production expanded by 4.4% in 2006 compared with 0.8% in 2005 and continued to grow, by 5.1% on a year-on-year basis, during the first seven months of 2007. This was driven by strong gains in the food industry and production of base metals. Overall, the Serbian economy continued to grow due, in part, to the relaxation of fiscal policy, laxer wage policy and strong export performance.

The current account deficit widened to 11.5% of GDP in 2006, from 8.4% in 2005, partially caused by an increase of the trade deficit to 19.6% of GDP. Exports grew faster than imports, expanding by 30% and 25% year-on-year, respectively. However, exports remained small, accounting for about 58% of imports only. Financing of the external deficit has improved and foreign direct investment (FDI), after reaching a record 13% of GDP, more than covered the current account deficit for 2006. Foreign debt financing, primarily to the private sector, totalled EUR 2.3 billion or 9% of GDP. As a result of these strong capital inflows, the foreign exchange reserves of the National Bank of Serbia (NBS) grew by EUR 2.7 billion to EUR 9 billion, equivalent to 10 months' imports of goods and services.

In the first half of 2007, exports and imports of goods and services grew by 43.3% and 39.4% respectively on a year-on-year basis and the trade deficit widened to about 22% of GDP. The current account deficit increased to about 14% of GDP as a result of the growing
trade deficit, but also due to a significant drop in current transfers. Nevertheless, capital inflows remained strong during the same period amounting 18% of GDP. FDI declined to about 4% of GDP.

**Serbia - Main economic trends**

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross domestic product Ann. % ch</th>
<th>Private consumption Ann. % ch</th>
<th>Gross fixed capital formation Ann. % ch</th>
<th>Unemployment %</th>
<th>Employment Ann. % ch</th>
<th>Wages Ann. % ch</th>
<th>Current account balance % of GDP</th>
<th>Direct investment (FDI, net) % of GDP</th>
<th>RPI Ann. % ch</th>
<th>Interest rate (3 months) % p.a.</th>
<th>Bond yield % p.a.</th>
<th>Stock markets Index</th>
<th>Exchange rate CSD/EUR Value</th>
<th>Nominal eff. exchange rate Index</th>
<th>General government balance % of GDP</th>
<th>General government debt % of GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>4.2</td>
<td>N.A.</td>
<td>N.A.</td>
<td>13.3</td>
<td>N.A.</td>
<td>31.3</td>
<td>-12.0</td>
<td>3.3</td>
<td>21.4</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>60.74</td>
<td>101.5</td>
<td>-3.1</td>
<td>80.6</td>
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<tr>
<td>2003</td>
<td>2.5</td>
<td>N.A.</td>
<td>N.A.</td>
<td>14.6</td>
<td>-1.2</td>
<td>13.4</td>
<td>-10.1</td>
<td>6.9</td>
<td>11.7</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>65.29</td>
<td>97.3</td>
<td>-1.1</td>
<td>70.9</td>
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<tr>
<td>2004</td>
<td>8.4</td>
<td>N.A.</td>
<td>N.A.</td>
<td>18.5</td>
<td>0.2</td>
<td>13.9</td>
<td>-13.1</td>
<td>4.3</td>
<td>17.3</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>73.10</td>
<td>93.5</td>
<td>0.9</td>
<td>56.7</td>
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<tr>
<td>2005</td>
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<td>N.A.</td>
<td>18.5</td>
<td>0.4</td>
<td>7.0</td>
<td>-8.0</td>
<td>5.7</td>
<td>17.2</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>83.25</td>
<td>92.7</td>
<td>1.9</td>
<td>52.9</td>
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<td>2006</td>
<td>5.7</td>
<td>N.A.</td>
<td>N.A.</td>
<td>20.8</td>
<td>-1.4</td>
<td>11.7</td>
<td>-11.3</td>
<td>13.6</td>
<td>13.48</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>83.91</td>
<td>103.9</td>
<td>1.6</td>
<td>34.9</td>
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<tr>
<td>2007</td>
<td>8.1 H1</td>
<td>N.A.</td>
<td>N.A.</td>
<td>21.0</td>
<td>-1.2</td>
<td>16.9</td>
<td>6.1</td>
<td>13.6</td>
<td>6.0</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>1,494</td>
<td>79.51</td>
<td>1.2</td>
<td>31.8</td>
</tr>
</tbody>
</table>

Sources: Eurostat, Reuters/Ecowin, National sources

Portfolio investment picked up substantially, reaching about 3% of GDP, attracted by strong gains at the Belgrade stock exchange and relatively high domestic interest rates. During the same period, the amount of medium- and long–term loans accounted for about 11% of GDP. External debt grew to €16.8 billion, equivalent to about 60% of GDP, by the end of July 2007. Private- and public-sector external debt stood at 35% and 25% of GDP respectively. Overall, while the current account deficit grew, the inflow of foreign capital into the economy remained strong.

As a consequence of corporate restructuring, employment declined by 2.1% in 2006. Small- and medium-sized enterprises and the private sector in general are playing a growing role in job creation. However this was not enough to result in net job growth during 2006. Official unemployment figures stood at approximately 22% of the total workforce at the end of 2006. During the first half of 2007 the official figures on unemployment dropped by about 4% on a year-on-year basis. Youth unemployment (amongst under-24s) remains very high at 49% of the total workforce in that age group. About 30% of the active population is reportedly engaged in the grey economy. Overall, despite high economic growth rates in recent years, unemployment is still a major challenge. Labour market inflexibilities and high social security contributions remain another obstacle to job creation in the formal sector.

As far as monetary policy is concerned, in response to strong capital inflows and in order to prevent excessive appreciation of the dinar, the National Bank of Serbia (NBS) continued to intervene in the foreign exchange market in late 2006. In addition, the reference interest rate of the NBS was lowered in several steps from 18% in September 2006 to 9.5% in May 2007. This did not prevent the dinar from strengthening further against the euro. In all, the
dinar appreciated by 7.6% in 2006. As a result of capital inflows and the related foreign exchange interventions, money supply rose by 47% on a year-on-year basis in 2006. In order to counterbalance the liquidity effect of the foreign exchange operations, the NBS increased sales of NBS and treasury bills, which constituted the major monetary policy instruments in the last four months of 2006. In addition, the NBS raised the reserve requirements for the foreign currency deposits of banks. However, as inflation slowed, reserve requirements were again lowered to 45% on foreign currency deposits and to 10% on dinar deposits in January 2007.

During the first four months of 2007 the dinar depreciated slightly, losing 2.2% of its nominal value against the euro, partly as a result of the growing market unease over delays in formation of the government. The NBS decided to leave setting of the exchange rate, by and large, to market forces, but also announced that it intended to continue to play a role in preventing excessive daily fluctuations. Overall, monetary policy continued to be challenged by strong capital inflows and the appreciation of the local currency. The policy of allowing the exchange rate to be determined by market forces has proved appropriate and conducive to reducing inflation.

In 2006, retail price inflation stood at 12.7%, compared with 17.3% a year earlier. Core inflation, which excludes prices for agricultural products, energy and communal services, stood at 10.3%. The progressive decline in inflation was mainly due to the appreciation of the dinar, falling international oil prices and delays in increasing prices for communal services. From January to August 2007, the average annual inflation rate stood at 5.6%. Overall, inflation has continued to decline and this has contributed to a stable environment for economic operators.

In 2006, the consolidated government budget recorded a surplus of 1.6% of GDP (including proceeds from the sale of a mobile telephone operator licence). This compares with a surplus of 1.9% of GDP in 2005. Non-tax revenue, including from the licence fee for the mobile operator, grew by 1.2 percentage points of GDP. Expenditure declined marginally by 0.1% of GDP to 38.1%. Cuts were recorded in subsidies, interest payments, social security and pensions. However, revenue fell by 0.3% of GDP to 39.1%. Tax revenue in 2006 declined by 1.5% of GDP, mostly driven by a 1.7 percentage point drop in revenue from VAT. This was only partly offset by a 0.5 percentage point gain in personal and corporate income tax.

After a start was made with putting into action the national investment plan (NIP), an increase of 1.2 percentage points of GDP was recorded for capital expenditure. In addition, expenditure on public-sector salaries and social welfare grew by 0.2 and 0.3 percentage points to 9.7% and 3.6% of GDP respectively.

Overall, the upward trend in public expenditure during recent years was interrupted in 2006. In addition, there was a rebalancing of expenditure away from consumption towards investment. However, fiscal policy turned more expansionary in the second half of 2006 and early 2007. Wage policy, in particular, became substantially relaxed ahead of general elections.

Consequently, the 2007 budget envisages a deficit of about 0.5% of GDP, driven by an increase in expenditure to 41.4% of GDP, mainly due to a substantial rise in public-sector salaries agreed by the previous government ahead of general elections and higher investment. The latter partly reflects the fact that the NIP is now included in the budget.
Revenue is projected to increase to 40.9% of GDP\textsuperscript{14}. Overall, the recent relaxation of fiscal policy has contributed to external imbalances and inflationary pressures.

General government debt declined by about 15 percentage points of GDP to about 35%, due to debt write-offs and early repayments to international financial institutions. In January 2007, amendments to the personal income tax law came into force, reducing the tax rate on salaries by 2 percentage points to 12% and introducing a tax-free allowance of 5,000 dinar per month.

As regards macroeconomic policy mix, fiscal policy turned expansionary while monetary policy remained rather restrictive. Reserve requirements, in particular on foreign currency deposits, have been raised substantially to curb credit growth. Overall, the macroeconomic policy mix has not been entirely adequate, as the reversal of fiscal consolidation has added to fiscal and macroeconomic risks. In addition, the relatively large size of the public sector has been curbing the prospects for faster economic development.

\textit{Interplay of market forces}

Privatisation of socially-owned companies continued in late 2006 and the first half of 2007, both by tenders and by auctions. About 300 socially-owned companies were sold in 2006 followed by some 100 more in the first half of 2007. The total number of socially-owned companies privatised since the start of the process climbed to almost 2,000 by mid 2007. However, 1,200 socially-owned companies have yet to be privatised and the deadline for completing this process has been extended by one year until the end of 2008. A commission for the privatisation of public utilities has been set up and the government plans to privatise two state-owned companies by the end of the year. However, there is still no clear strategy for privatisation of state-owned companies. The situation of heavily indebted conglomerates has not yet been adequately addressed. Bankruptcy procedures have been slow due to lack of qualified bankruptcy administrators and delays in commercial courts.

In the last quarter of 2006 and the first quarter of 2007 no progress was recorded on restructuring and privatising large and highly inefficient state-owned companies. The new government, which took office in mid-May, has stated that it intends to relaunch the privatisation of NIS and of the national air carrier JAT Airways. A privatisation strategy for NIS is expected to be adopted soon and the tender for sale of an initial minority stake of 25\% could be launched in autumn 2007. The sale of JAT Airways has been announced and several potential bidders have been identified. There has been little progress, however, on privatising other inefficient state-owned companies.

The share of the private sector has not changed significantly and remains relatively low at about 55\% of total output. The private sector accounts for about 60\% of total employment. State-owned and socially-owned enterprises still generate a large part of Serbia's output. The absence of a larger share of private-sector activity is an obstacle to developing competitive domestic products and services, and risks affecting adversely inflation and external accounts. In addition, unviable public companies continue being a burden for public finances. Overall, despite the progress made with privatisation in recent years, a competitive and dynamic private sector has not yet been fully established.

\textsuperscript{14} According to the IMF definition of fiscal deficit, the fiscal deficit in 2006 totalled 1.5\% of GDP and is projected to rise to 2.7\% of GDP for 2007. This suggests a looser fiscal stance for both years, an increase in expenditure in 2006 and slower fiscal expansion in 2007 than official figures indicate.
The economy still has to cope with a high proportion of administered prices (34.7% of the retail price index).

**Market entry and exit**

In 2006, the number of newly registered companies increased by 7.6%. About 3,000 new companies were registered in the first half of 2007. The business environment improved in 2006, in particular access to financing and trading across borders. However, dealing with licences, registering property, enforcing contracts and closing a business can all be improved. A deterioration was notable in procedures related to starting a business and to labour market regulation. In 2006, 269 bankruptcy procedures were initiated and only 66 cases were closed, bringing the number of pending cases to 1,266. Until August 2007, 76 new bankruptcy procedures were initiated. The number of pending bankruptcy procedures grew to 437 of which some cases now last for seven or eight years. Overall, despite some progress, excessive bureaucratic requirements and complex legislation are continuing to hamper market entry and exit.

**Legal system**

The new constitution recognises private ownership of construction land. No progress has been made on promulgating a restitution law or policy. Overall, the judicial system continues to suffer from slow and inefficient court proceedings, poor case management and limited administrative capacity. These circumstances deter economic operators from taking cases to court and undermine effective enforcement of creditor and property rights.

**Financial sector development**

In 2006, lending activity of banks increased by 25.5%. Loans totalled about 21% of GDP and 46.6% of the banking sector's balance sheet. This is somewhat lower than the 55% recorded a year earlier, due to the significant increase in reserve requirements in 2006 in an attempt by the NBS to curb credit expansion. At the same time, the total assets of the banking system grew by 51%. Liabilities to clients grew by 41% and account for 70% of the banking sector's total liabilities. Total deposits grew by 37.5% in 2006 and foreign currency deposits accounted for 65.9% of total deposits. Foreign loans taken by Serbian banks almost doubled in 2006 to about €2.3 billion, of which 98% have a maturity of over one year. Overall, financial intermediation by banks has continued to grow but from a still relatively low level.

In 2006, four majority state-owned banks were sold to foreign financial institutions. As a result, the share of the remaining state-owned banks in total assets declined to 14.9% at the end of 2006 compared with 36.1% at the end of 2004. The number of majority state-owned banks shrank to 8 (out of a total of 37), while 22 banks are now majority-owned by foreign shareholders. The five largest banks in terms of balance sheet accounted for 47.2% of the entire banking sector. Overall, privatisation of the state-owned banks is well advanced and competition between banks is well established.

At the end of 2006, 33% of the banking sector's total assets were classified as risky. Although this is somewhat higher than a year earlier, the increase is mainly attributable to a new methodology applied by the NBS. Under the old methodology, 23.8% of the sector's total assets would have been considered risky. The capital adequacy ratio of the banking system averaged 24.7% and, consequently, remained well above the required minimum of 12% of risk-weighted assets for each bank. The profitability of the banking sector has improved and the return on equity increased to 9.7% from 6.5% a year earlier. Overall, the
banking sector is exposed to a relatively high number of risky assets. However, this sector is profitable and remains generally sound.

Financial markets posted strong gains in 2006. The two indices of the Belgrade stock exchange gained 22.4% and 58% respectively and reached historic highs. Volatility of stock prices increased in 2007, following strong gains in the first quarter of 2007. Total market capitalisation of companies traded at the Belgrade stock exchange rose significantly to over € 15 billion or about 45% of GDP in July 2007 from about 23% in July 2006.

A number of by-laws on voluntary pension funds and pension schemes were passed. The security and exchange commission adopted rules on acquisition of titles and licences for brokers, investment advisers and portfolio managers. At the end of 2006, 17 insurance companies were operating in the country. Premiums grew by an annual 12% to 1.5% of GDP. The market remains relatively concentrated as the three largest insurers accounted for 75% of total premium income. Foreign ownership is still relatively small at 26.4% of total premium income, but accounts for 83.5% of the life insurance market. The structure of the insurance sector is changing substantially since privatisation of socially-owned insurance companies started and the arrival of foreign greenfield investments in this sector. Overall, tangible progress has been made with developing the non-banking financial sector.

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

Existence of a functioning market economy

Macroeconomic stability was strengthened in 2006 and the first months of 2007, allowing economic operators to make decisions in a climate of relative stability and predictability. However, the functioning of market mechanisms which allow efficient allocation of resources is still hampered by the large proportion of administered prices, the small private sector, market distortions, inflexible labour market regulation and heavy involvement of the state sector in the production of private goods.

Human and physical capital

Reforms of the education system have continued. However, the lack of adequately educated personnel is often identified by foreign investors as an obstacle to further investment. The reform to bring the higher education system into line with the Bologna requirements has started. Efforts need to continue in order to link the university education and curricula with the labour market and economic needs. Progress can also be reported on endorsement of the framework policy documents to develop vocational education and training (VET). Further action is now needed to implement the policies and to strengthen coordination between VET, university education and other sectors of education and the labour market. Administrative capacity also needs to be strengthened. The share of education in overall public expenditure remains low at 3.5% in 2006. Overall, the labour market is still suffering from a mismatch between supply and demand as well as lack of funding.

In 2006, gross fixed capital formation grew by 15.4%. The investment ratio rose to 17.9% of GDP from 15.8% a year earlier. Foreign direct investment (FDI) reached a record 13% of GDP in 2006, mainly due to privatisation and acquisitions in the telecommunication sector, pharmaceutical industry and financial services. This trend, however, slowed during the first half of 2007 when net FDI amounted to about 4.1% of GDP.
In March 2007, a concession contract was signed between the government and a foreign consortium to build and maintain a highway between the northern border town of Horgoš and Pozega in western Serbia. This investment is worth 3.2% of GDP. However, it is not clear whether this project is economically viable, as technical and financial details have not been made public. In addition, a major greenfield investment was recorded in 2006, when a foreign company entered into a joint venture to develop a business park worth 0.5% of GDP. The national investment plan (NIP) envisaged investment in transport infrastructure, mainly national primary roads, worth 1.8% of GDP. However, due to delays in implementation of the NIP, projects have not advanced as quickly as planned. Overall, investment activity has improved markedly which bodes well for raising the productive potential of Serbia.

**Sectoral and enterprise structure**

The new government has shown some willingness to accelerate the process of selling state-owned companies. However, restructuring and privatisation have been very slow. The shift of economic activity towards the services sector has continued, with services currently accounting for 41.6% of GDP. Manufacturing and construction now account for 13.6% and 2.9% of GDP respectively, while the share of agriculture has declined slightly but remains at 10.9% of GDP. In terms of employment, 50.2% of the total number of employed persons working in the services sector, 29.3% in industry and 20.5% in agriculture.

SMEs account for 99% of the total number of entities, providing 60% of the total number of jobs, and are involved in 65% of total trade. Their share of gross added value has grown to 54%. Despite improvements in the business environment, obstacles to SMEs remain, such as the low level of liquidity, high indebtedness and little access to long-term financing. Overall, SMEs have grown in importance despite the remaining obstacles.

**State influence on competitiveness**

Subsidies from the consolidated state budget accounted for 2.6% of GDP in 2006, down from 3.1% a year earlier. State-controlled monopolistic structures remained in place, such as the import ban on refined petroleum products to protect the domestic refinery industry from foreign competition. Relevant by-laws to the law on state aid control have still not been passed. This is hindering establishment of appropriate monitoring mechanisms, such as the commission for state aid control. Overall, state intervention in the enterprise sector remains substantial.

**Economic integration with the EU**

In 2006, exports and imports of goods and services accounted for 27% and 47% of GDP respectively, virtually unchanged from 2005. The EU continued to be Serbia's main trading partner. Exports and imports of goods and services to and from the EU accounted for 53% and 49% of total exports and imports respectively. In the first seven months of 2007, exports to the EU grew by 35% year on year to 58% of total exports, while imports from the EU rose by 31% to 56% of total imports. The accession of Bulgaria and Romania to the EU in January 2007 explains partially these figures. Serbia's other leading trading partners remain other Western Balkan countries, in particular Montenegro and Bosnia and Herzegovina, along with Russia and China. Overall, foreign trade has continued to grow and trade integration with the EU has advanced.

WTO accession negotiations have been a powerful catalyst for agricultural reform. In 2006, FDI from the EU added up to 61% of total FDI inflows into Serbia, compared with 95% a
year earlier. This is mainly due to the fact that a non-EU company made a major investment in Serbia in 2006.

Real wages grew by 13%, thus more than average labour productivity (8%), with the result that real unit labour costs rose by 5%. The nominal effective exchange rate of the dinar appreciated by 12% in 2006, largely due to its strong appreciation against the euro and the US dollar. In real effective terms, the dinar appreciated by a higher rate (16.5%), as consumer prices grew faster on the domestic market than abroad. This trend slowed down during the first six months of 2007, when the dinar appreciated by 0.6% and 2.9% in nominal and real terms respectively. Overall, standard indicators suggest no significant deterioration in export price competitiveness.

Average per capita income in 2006 increased to 22% of the EU-27 average in purchasing power standards, from 21% in 2005.

8.4. Conclusions

Serbia’s economy has continued to grow strongly but progress in macroeconomic stabilisation was mixed. The reversal of fiscal consolidation added to fiscal and macroeconomic risks. Much needed structural reforms continued slowly and the high level of unemployment remained a major challenge.

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

The authorities have to a large extent maintained the main elements of a sound economic policy. The economy continued to expand strongly. The inflow of foreign capital remained significant. Declining inflation contributed to a stable environment for economic actors. The budget remained in surplus and investment activity has improved markedly.

The privatisation of state-owned banks is well advanced and competition among banks is strong. The new government has shown limited willingness to revive the process of privatising state-owned companies. The SME sector has grown in importance. Foreign trade and investment continued to grow and economic integration with the EU has advanced.

However, despite strong economic performance, unemployment remains very high. Further progress in privatisation is needed and a competitive and dynamic private sector has not yet been fully established. Fiscal policy turned expansionary in the second half of 2006 and in 2007. Public sector wages increased substantially. This contributed to a sizeable increase in expenditures as a percentage of GDP in 2007 and added to external imbalances and inflationary pressures. The lack of flexibility in the labour market and high social security contributions remain an obstacle for job creation. Investment has been hampered by excessive bureaucratic requirements and complex legislation. Commercial courts continued to suffer from limited capacity and expertise. The large informal sector, fuelled by weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
9. KOSOVO (UN 1244)

9.1. Introduction

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

9.2. The existence of a functioning market economy

Economic policy essentials

The special political situation in Kosovo, combined with the division of responsibilities between the Provisional Institutions of Self-Government (PISG) and the United Nations Interim Administration Mission in Kosovo (UNMIK), have an effect on economic policy. The uncertainty over the future political status of Kosovo affects every area of economic policy.

Some progress has been made towards creating an enabling environment for a successful transition to a functioning market economy. The 2006 budget, like the current one, remained on track, as the government remained committed to keeping fiscal policies on a sustainable path. Kosovo has adopted a mid-term expenditure framework 2008-2010 which quantifies its spending needs and defines policy choices and investments in a number of key sectors. However, the prioritisation of key expenditure has not taken place in an orderly way. The difficulties with securing an overall political consensus in order to respect policy commitments were partly due to lack of co-ordination within the government, in particular between the Ministry of Finance and Economy and line ministries during both the strategy definition and implementation phases. Furthermore, an understanding with the IMF on a Memorandum on Economic and Financial Policies was delayed as the government made no progress on prior action requested by the Fund. Overall, the economy and economic policies are affected by the uncertainty over the future status of Kosovo. Within this context, the policies in place were broadly sound and market-oriented. Even so, economic policy co-ordination remained weak.

Macroeconomic stability

Real output grew by an estimated 3.8% in 2006 after an increase by 0.6% in 2005. The decrease in foreign assistance was compensated by growth in other sectors. Consumption by private households increased by almost 5% in nominal terms, whereas nominal output, as measured by GDP, grew by only around 2%. Public consumption showed a differentiated picture, as government wages grew in line with private household consumption, whereas growth of public consumption of goods and services was flat. Donors' consumption decreased across all categories (wages of expatriates, wages of locally employed persons, consumption of goods and services). General government investment expenditure fell by more than one third as only 70% of budgeted investment spending was actually spent. Donor-financed investment shrank by 15% and, as a consequence, its share in total investment fell to 11% in 2006, down from 14% in 2005. Private investment continued to

15 National accounts aggregates (GDP and its subcomponents) are based on June 2007 IMF estimates.
grow at a brisk pace – by 32% in 2006, up from 24% in 2005. Within this category, private housing investment grew at 9.4% after 8.8% in 2005, whereas private non-housing investments increased sharply, by 60% in 2006 after 50% in 2005. Thus, for the first time, private non-housing investment overtook housing investment in relative terms, growing to 12.6% of GDP in 2006 with overall investment (both private and public) standing at 31.3% of GDP in 2006, up from 29.1% in 2005. Overall, there has been a resumption of growth, albeit moderate.

**Kosovo - Main economic trends**

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Gross domestic product</strong></td>
<td>Ann. % ch</td>
<td>-2.4</td>
<td>-0.1</td>
<td>2.0</td>
<td>-1.0</td>
<td>3.1</td>
</tr>
<tr>
<td><strong>Private consumption</strong></td>
<td>Ann. % ch</td>
<td>0.3</td>
<td>1.9</td>
<td>3.6</td>
<td>5.8</td>
<td>4.4</td>
</tr>
<tr>
<td><strong>Investment (Gross fixed cap form)</strong></td>
<td>Ann. % ch</td>
<td>-12.8</td>
<td>-7.4</td>
<td>12.2</td>
<td>-5.9</td>
<td>10.4</td>
</tr>
<tr>
<td><strong>Unemployment</strong></td>
<td>%</td>
<td>47.0</td>
<td>49.7</td>
<td>39.7</td>
<td>42.2</td>
<td>40.0</td>
</tr>
<tr>
<td><strong>Employment</strong></td>
<td>Ann. % ch</td>
<td>9.7</td>
<td>-24.8</td>
<td>4.7</td>
<td>-4.6</td>
<td>:</td>
</tr>
<tr>
<td><strong>Wages</strong></td>
<td>Ann. % ch</td>
<td>N.A.</td>
<td>2.0</td>
<td>9.3</td>
<td>8.5</td>
<td>:</td>
</tr>
<tr>
<td><strong>Current account balance</strong></td>
<td>% of GDP</td>
<td>-18.0</td>
<td>-18.2</td>
<td>-20.0</td>
<td>-24.0</td>
<td>IMF Proj.</td>
</tr>
<tr>
<td><strong>Direct investment (FDI, net)</strong></td>
<td>% of GDP</td>
<td>0.4</td>
<td>0.8</td>
<td>0.9</td>
<td>3.7</td>
<td>10.8</td>
</tr>
<tr>
<td><strong>CPI</strong></td>
<td>Ann. % ch</td>
<td>2.0</td>
<td>1.2</td>
<td>-1.1</td>
<td>-1.4</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Interest rate (3-12 months)</strong></td>
<td>% p.a.</td>
<td>15.60</td>
<td>14.60</td>
<td>15.70</td>
<td>15.60</td>
<td>15.47</td>
</tr>
<tr>
<td><strong>Bond yield</strong></td>
<td>% p.a.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td><strong>Stock markets</strong></td>
<td>Index</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
<tr>
<td><strong>Exchange rate EUR/EUR Value</strong></td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td><strong>Real eff. exchange rate (CPI)</strong></td>
<td>Index</td>
<td>0.9</td>
<td>-0.9</td>
<td>-3.0</td>
<td>-5.0</td>
<td>-2.8</td>
</tr>
<tr>
<td><strong>General government balance</strong></td>
<td>% of GDP</td>
<td>4.4</td>
<td>2.5</td>
<td>-6.1</td>
<td>-3.2</td>
<td>3.6</td>
</tr>
<tr>
<td><strong>General government debt</strong></td>
<td>% of GDP</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
<td>N.A.</td>
</tr>
</tbody>
</table>

Sources: Eurostat, Reuters/Ecowin, National sources, IMF

After 3.7% in 2005, imports of goods and services increased by 10.4%. Within private-sector imports, final consumption goods grew at a rate of 12.9%, whereas imports of investment goods were up 36.5% in 2006. The trade deficit (goods only) widened further to 53% of GDP in 2006 from 48% in 2005 and the trend continued during the first half of 2007. The ratio of exported to imported goods increased but remained very low at 8.5% in 2006, reflecting the lack of export capacity and competitiveness, two major weaknesses of the Kosovo economy. The current account deficit – not taking into account foreign assistance – remained roughly stable at around 19% of GDP in 2006 after 18.5% in 2005. The level of foreign assistance decreased from 21% of GDP in 2005 to 18% in 2006 and private capital transfers were substantial (around 20% of GDP in 2006). Foreign direct investment (FDI) inflows, on the back of accelerated privatisation activity, rose to around 10% of GDP in 2006 after only 3.5% in 2005. Overall, the external accounts of Kosovo remained precarious.

At the end of 2006, the number of registered unemployed persons has increased by 2.4% compared to 2005, and rose further in 2007. 47% of the unemployed persons are women.

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16 The bulk of foreign direct investment inflows finances privatisation. Privatisation proceeds are currently deposited in an escrow account and invested in securities abroad and do not yet finance real activity in the Kosovo economy (such as investment or consumption).
The poor availability of official employment data makes it difficult to analyse labour market developments. The lack of economic and social statistics is a general feature of the Kosovo economy. According to the labour force survey, unemployment stood at 44.9% of the active labour force in 2006. However, a large number of registered unemployed may be active in the informal economy. Overall, registered unemployment remains high and has been growing steadily. However, partly due to the estimated size of the grey economy, registered unemployment does not yet systematically reflect the dynamics of the economy.

Consumer price inflation in 2006 was, at 0.6%, slightly positive, after two years of falling prices. From January to August 2007, the average annual inflation stood at 1.9%, due to a sharp acceleration in food prices in August. In general, inflation was driven by world price trends whereas in the case of domestically produced goods and services inflation growth tended to be negative.

The 2006 budget outcome recorded a surplus of 3.6% of GDP, instead of a budgeted deficit of 2.0%. This surplus was due, on the one hand, to revenue growth higher than planned, mainly due to more efficient tax collection, and, on the other, to a capital expenditure execution rate of only 70%, reflecting limited administrative, public procurement and project management capacity. With current spending under control and partly due to extraordinary revenues, the budget recorded a surplus of 8.6% of GDP at the end of September 2007. The share of government expenditure decreased from 31.1% of GDP in 2005 to 29.2% in 2006. By functional classification, economic affairs accounted for 24% of public expenditure (29% in this category were subsidies, mainly to publicly owned enterprises (POEs), and 59% were capital outlays), social protection 21%, education 18%, public order and safety 12% (wages in that category made up one fifth of all public wages), general public services 11% and health 10%. Overall, the fiscal stance remained more restrictive than initially planned, but highly volatile, with expenditure below the budget limits set and revenue performance better than anticipated. Due to its current political status, Kosovo cannot take on any public external debt.

In the absence of monetary policy, given that Kosovo uses the euro as legal tender, the budget is the only viable tool for macroeconomic policy in Kosovo. Due to the unintended strong fiscal consolidation, the overall policy mix was inadequate.

Interplay of market forces

In 2006, private-sector consumption accounted for 74% of total consumption. The share of private investment increased from 62% of total investment in 2005 to 75% and the share of private imports increased from 74.2% in 2005 to 80.2%. Substantial progress was made with the privatisation of formerly socially owned enterprises (SOEs). However, some big SOEs, along with SOEs in Serbian enclaves, still remain to be privatised. In July 2007, the Kosovo Trust Agency (KTA) decided to launch the 28th wave of privatisation, comprising mainly shops and agricultural lands. As of 30 June 2007, €315 million from privatisation had been paid into escrow accounts, of which more than €60 million were scheduled for distribution to former SOE workers. A large proportion of these funds currently remains blocked, pending the adjudication of claims. The government started the incorporation of seven regional water companies in December 2006 and the incorporation of the irrigation and waste enterprises in March 2007. Serbia, however, continued to oppose the ongoing privatisation process led by UNMIK, arguing that it infringes property rights, and Serbian

17 20% of privatisation receipts are scheduled to be paid out to former SOE workers. €12 million have been paid out so far to the Independent Union of Trade Unions of Kosovo which disburses the funds to the workers.
citizens filed numerous complaints on this issue. Overall, the ongoing expansion of the private sector reflected the acceleration of the privatisation process in 2006.

**Market entry and exit**

The number of registered businesses in Kosovo rose by 13% in 2006 to more than 57,000. Information on barriers to market entry and exit has become more detailed and more reliable. More than 50% of enterprises stated that obtaining a business licence or permit, together with compliance with customs regulations, posed a problem when it came to doing business. Uncertainty about regulatory policies and the cost of and access to financing also create problems. More than 80% of new investments were financed from own resources. The main reported reason for not having recourse to formal borrowing was that interest rates were too high. 70% of businesses perceived tax rates as too high and every second business perceived labour regulations as too restrictive. Market exit remained a lengthy process: the KTA board has so far approved 84 liquidations of former SOEs. The Ministry of Finance and Economy sent a draft law on bankruptcy and liquidation to the government on 5 October 2006, since when it has been awaiting final approval and promulgation. Overall, limited access to finance, red tape and legal uncertainty (among others, about property ownership) continue to weigh negatively on market entry. Now that comprehensive surveys on the situation of small and medium-sized enterprises (SMEs) have become available, it turns out that the optimistic results of an earlier study on the business environment from the perspective of a large foreign investor do not carry over to the situation of SMEs doing business in Kosovo.

**Legal system**

Use of the courts to resolve property issues remains underdeveloped. Corruption and uncertainty over property rights remain a major impediment to economic activity, due partly to Kosovo's final political status being unresolved and partly to disputed land registries or missing business cadastres. In general, the deficient rule of law is hampering business development.

**Financial Sector development**

The level of financial intermediation increased further, even though from a low basis, as bank loans to the private sector rose to 26.1% of GDP by the end of 2006. Credit growth remained between 20% and 25% year on year. Almost all of this was due to increased lending activity during 2006 by the two large foreign-owned banks operating in Kosovo. 77.1% of outstanding loans were to non-financial corporations, the vast majority of which are SMEs. In 2007, a Slovenian bank bought majority shares in two major Kosovo banks: 51.4% of KASABANK and 75% of Banka e Re e Kosoves (BRK). Also, the National Commercial Bank of Albania has received a (preliminary) licence allowing it to operate in Kosovo. After this consolidation, the five largest banks hold 98% of the total assets of domestic credit institutions, with the three large foreign-owned banks alone controlling 91%. Overall, the financial sector has further expanded and consolidated in a context of increased foreign ownership.

The interest rate spread remained very high at 10.4% as, at the end of 2006, on average 3% were paid on deposits and 13.4% on loans. More than half of the spread is related to operating costs, whereas the rest reflects risk premiums due to uncertain property rights. The loan-to-deposit ratio stood at 68.7% at the end of 2006. Non-performing loans stood at 4.1% of total loans by the end of 2006. Consequently, neither of these prudential indicators in the banking sector pointed to any major systemic risk. Nor did the withdrawal of a
banking licence in 2006 trigger any negative repercussions. Overall, the systemic risk in the banking sector appears to be low, but financial intermediation continues to suffer from high interest rate spreads, costly collateral registration, deficient cadastral procedures and weak credit information procedures.

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

*Existence of a functioning market economy*

In general, Kosovo has developed an appropriate legislative and institutional framework for a functioning market economy. However, implementation and enforcement of this framework remain weak. Kosovo has achieved a certain degree of macroeconomic stability, as fiscal accounts have shown a better than expected turnout and inflation has remained low. The estimated economic growth of close to 4% of real GDP in 2006 was entirely due to the private sector's resilience in an environment of negative government expenditure growth and further declining donor support. Overall, status-related uncertainties, fiscal risks and external imbalances continue to weigh negatively on the predictability of the business climate and the reliability of market allocation mechanisms.

*Human and physical capital*

Around one fifth of the population were enrolled in education, of whom 78% in pre-school and primary education, 16% in secondary education and 6% in tertiary education. School enrolment in Kosovo remains low, with under 90% of the age cohort in the final year of compulsory (lower secondary) education. Under 55% were still enrolled at the 12th grade of upper secondary education (necessary for qualified workers or university entrance). Schools continue to operate on multiple shifts (up to four) due to lack of classrooms. The government has continued to invest, with donor assistance, in training and requalification with a focus on young persons, minorities, women and persons with disabilities. Overall, progress has been made with enhancing education. However, the physical condition of school infrastructure remains poor, as schools lack appropriate buildings, didactic material and equipment. In addition, low training capacity is continuing to slow down development of a proper education system needed for enhancing human capital.

Mobile phone penetration has increased rapidly. In March 2007, the telecom regulatory authority awarded the second mobile phone operating licence to a consortium formed by Ipko-Net and Telecom Slovenije/Mobitel. Pristina International Airport received a € 13.5 million loan that will be used for the upgrade of the airport's infrastructure necessary to obtain a licence for 24-hour operation. Little progress has been made on road, railway and high-speed telecommunications infrastructure. The poor transport infrastructure hinders expansion of private-sector activity, and SMEs suffer from limited access to online services. The lack of both transport and internet infrastructure hamper access by Kosovo businesses to the EU market and limit the benefits from regional trade integration. The technology base of the economy remained extremely weak. Overall, the weak technology base (combined with a lack of price competitiveness) and the low endowment with qualified human capital remain major impediments to Kosovo's capacity to cope with competitive pressure and market forces.

*Sector and enterprise structure*

The authorities took preparatory steps towards future liberalisation of the network and
electricity-producing industries and continued the unbundling of electricity generation and distribution. KOSTT, a separate company operating the energy transmission system and network and energy trade, has been set up. Different regulatory authorities have been established for civil aviation, energy, mines and minerals, telecommunications, frequency management, water and waste. By the end of 2006, the mines and minerals regulator had issued 72 licences (15 for exploration and 57 for mining) and started to promote the potential in the sector in order to attract FDI. The enterprise structure remains dominated by micro-enterprises (98% of all enterprises) employing no more than nine persons but accounting for 56.1% of overall employment. There were only 36 large enterprises (with 250 employees or more). This category includes POEs and large SOEs and its share of overall employment was 28.4%. Almost half (47.8%) of all businesses were in retail and wholesale, followed by food processing (9.3%), construction and other social personal services (both 5.3%). The informal economy remains sizeable, affecting the competitiveness of the economy. Agriculture continues to suffer from unresolved property rights issues and poor levels of capital investment. As a consequence, Kosovo was unable to harness its potential for import substitution in the case of unprocessed and processed foodstuffs, thereby failing to use a powerful mechanism for reducing its external deficit. Overall, there has been little change in the sectoral structure of the economy.

**Government influence on competitiveness**

Public subsidies and transfers other than pensions and social assistance decreased from 4.3% of GDP in 2005 to 2.9% in 2006. One major item in this category of spending were subsidies to POEs (3.6% of GDP in 2005) of which KEK, the incumbent electricity company, continued to be the main beneficiary (2.5% of GDP), with TREPCA mines second (0.5%). In 2006, more than half of Kosovo's businesses claimed to suffer from anti-competitive practices. Political interference in the selection of members of the board and senior management of POEs remains pronounced. The government further intervened by refusing a raise in electricity prices proposed by the electricity regulator, encouraging households not to pay bills if the regulator did not revert to the old pricing scheme. Overall, government intervention has not been severely hampering private-sector competitiveness. However, due to a lack of ambition in the area of privatisation, poor POE corporate governance and government interference with the regulation of public utilities, the government has not been able to fully implement its policies in order to reap potential competitiveness gains.

**Economic integration with the EU**

The openness of the economy, as measured by the value of imports plus exports in goods and services as a percentage of GDP, increased to 77.9% in 2006, up from 71.4% in 2005. Base metals and base metal products continued to account for almost half of goods exports in 2006 and the first half of 2007. On the back of the strong investment activity, imports of machinery increased strongly in 2006, shifting the structure of imports from final consumption goods to investment goods. However, this trend did not continue into the first half of 2007.

The EU is the main trading partner of Kosovo. The share of exports bound for the EU decreased from 38% in 2005 to 34% in 2006. The EU's share of total imports showed an almost identical trend, decreasing from 38% in 2005 to 34% in 2006. Trade integration with neighbouring countries increased, as exports to the Balkan region as a whole rose by 58% (and imports by 2.5%) in 2006. The consumer price index based real effective exchange rate continued to depreciate, but at a more modest pace of 3.9% compared with 5% in 2005. Overall, the trade deficit remained considerable and the export base extremely weak.
According to IMF estimates, GDP per capita stands at roughly €1,100 which corresponds to just 5% of the EU-27 average.

9.4. Conclusions

Kosovo’s economic development continues to be seriously impeded by political uncertainties, insufficient rule of law, limited production capacity and weak infrastructure. The very high level of unemployment remains a major cause of concern. Economic policies remained broadly sound and some reforms were pursued but economic growth was again modest and external balances remained precarious.

As regards economic criteria, Kosovo has made limited progress towards establishing a functioning market economy. Further considerable reform efforts must be pursued to enable it to cope over the long term with competitive pressure and market forces within the Union.

Overall, economic policies remained broadly sound and market-oriented. Inflation was low and the price level of domestic goods and services fell. Budget implementation in 2006 and the first half of 2007 led to a significant surplus. This was largely due to an extraordinary and larger than expected increase in revenues as well as to the fact that the government investment spending fell short of budgeted figures. Kosovo did not assume any public external debt. Privatisation of formerly socially owned enterprises accelerated significantly although much remains to be done. The incorporation of publicly-owned enterprises is close to completion but restructuring needs to continue. The financial sector further expanded and consolidated in a context of increased foreign ownership.

However, growth was relatively modest and unemployment very high. Inadequate implementation of the rule of law, status-related uncertainties and fiscal risks continued to affect the functioning of market mechanisms and the business climate. Economic policy coordination remained weak, making it difficult to ensure a policy consensus and to respect policy commitments. The external accounts remained precarious, as the trade deficit widened further. Kosovo still lacks export capacity and competitiveness. The development of a viable private sector was hampered by limited access to finance, legal uncertainty, insufficient skills and training, the weak technology base and the poor state of the transport, energy and communication infrastructure. Financial intermediation continued to be hampered by high interest rate spreads. The large informal sector, fuelled by persistent weaknesses in law enforcement and the regulatory framework, reduces the tax base, hampers the government's capacity to implement economic policies and affects negatively the business environment.
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