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Progress Towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2015 assessments

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EUROPEAN ECONOMY

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European Commission

Directorate-General for Economic and Financial Affairs

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Institutional Paper 015

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* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

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INTRODUCTION

In this Institutional Paper the Directorate General for Economic and Financial Affairs brings together into a single document the economic chapters of the 2015 European Commission's country reports for the seven enlargement countries Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo[(*)], Montenegro, Serbia and Turkey. The reports assess progress achieved over the last 12 months in each of the countries, embedded in a broader assessment of trends over a 3 to 5 year horizon, with a view to advance necessary political and economic reforms as well as legal transformation in line with the EU criteria. The European Commission adopted the progress reports on 10 November 2015 as part of its 2015 Enlargement Strategy.

This introduction explains the methodology underlying these Reports that the Commission has been following since 1997 in order to carry out these assessments.

The purpose of this Institutional Paper is to facilitate the work of those scholars, researchers and analysts of the enlargement process, who are mainly interested in the economic aspects. As such, it represents only a part of the overall progress made by the enlargement countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2015 reports, i.e. the Commission staff working documents for each of the countries.

The conclusions of the assessments in the economic chapters, summarising the state of compliance with the Copenhagen economic criteria, are provided at the end of each country section in this publication.

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.

(*) This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

The economic sub-criteria

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

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

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

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

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

– broad consensus exists about the essentials of economic policy;

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

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

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

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

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

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

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

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

Progress towards meeting the economic criteria for EU accession: the EU Commission's 2015 assessments

1. ALBANIA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process. In order to improve their economic governance, in 2015 the enlargement countries were asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania is **moderately prepared** in developing a functioning market economy**. Some progress** was made, in particular in improving macroeconomic stability. However, significant challenges remain, in particular the need to lower the public debt burden. Growth prospects have been improving, but they are still vulnerable to constrained bank lending. With a narrow export and production base, the competitiveness of Albania's economy is weak. The private sector is held back by significant shortcomings in the regulatory environment and the rule of law. The level of unemployment and informal employment remains high.

In line with the ERP recommendations and in order to support long-term growth, in the coming year Albania should pay particular attention to:

→ sustaining fiscal consolidation and strengthening the budget management framework;

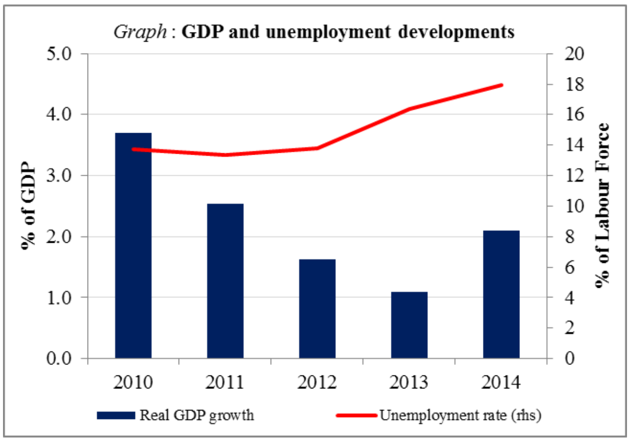
→ tackling the high level of non-performing loans;

→ improving the business environment by implementing regulatory reforms and adopting the new bankruptcy law.

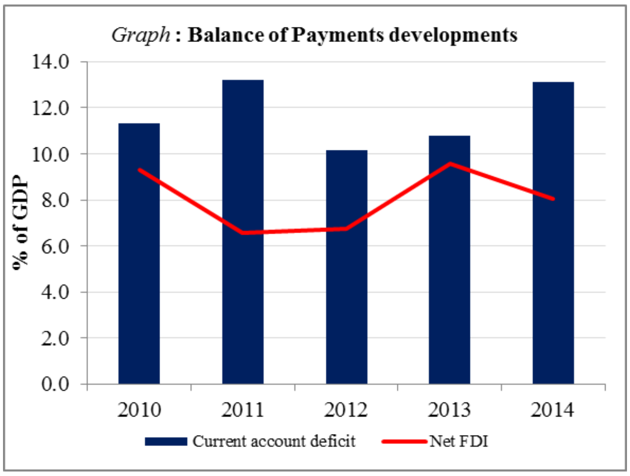
Economic policy essentials

The government demonstrated strong commitment to reform and implemented stability-oriented macroeconomic policies in a challenging political environment. Albania submitted its Economic Reform Programme, covering the period 2015-17, in January 2015. The objectives of the programme are to achieve macroeconomic stability, remove obstacles to growth and improve competitiveness. The ERP's medium-term macroeconomic projections assume a further acceleration of growth and continued fiscal consolidation on the basis of stability-oriented policies. Albania needs to follow up on its commitments and take further steps to implement the ERP recommendations, which are set out below. The three-year financing arrangement with the International Monetary Fund agreed in February 2014 supports strengthened macroeconomic stability and growth-boosting reforms.

Macroeconomic stability



Economic activity picked up in 2014 because of improved private domestic demand. The growth rate reached its lowest level in 15 years in 2013, at only 1.1 %. In 2014, however, growth rebounded to an estimated 2.1 % as interest rate cuts by the central bank improved financing conditions, rising remittances and low inflation boosted household spending, and the clearance of a large part of government arrears improved firms' liquidity and confidence. Annual economic growth reached 2.8 % in the first quarter of 2015, partly thanks to a strong increase in investment. Per capita GDP in purchasing power standards stood at only 29 % of the EU-28 average in 2014 (unchanged since 2009), pointing to the need to generate higher growth rates to converge towards EU living standards.



The current account deficit is structurally high, but its financing is healthy, relying mainly on non-debt-creating flows. Overall, the current account deficit increased to 13.1 % of GDP in 2014 from 10.8 % in 2013. The trade deficit increased to 18.8 % of GDP in 2014 after narrowing in 2012 and 2013. This was the result of higher imports due to recovering domestic demand, though exports, especially of clothing and footwear, also rose. The growing stock of foreign investment resulted in higher repatriation of investment earnings. The long-standing decline in migrant remittances was reversed in 2014, but in proportion to GDP they remain much below the level reached in the years leading up to the 2008 global crisis.

In the 2009-2014 period, around two thirds of net financial inflows to the economy consisted of foreign direct investment (FDI). External debt amounted to around 68 % of GDP at the end of 2014, with long-term debt making up more than 80 % of the total, mostly in the form of concessional government borrowing and inter-company lending. This debt profile does not give rise to concerns about refinancing prospects. Moreover, the official foreign exchange reserves, covering around 5.3 months of imports and amounting to almost double the stock of short-term external debt in the first quarter of 2015, provide an adequate safeguard against adverse shocks. To address the persistent current account deficit, Albania needs to diversify its economy and improve productivity by attracting foreign capital into tradable sectors among other things.

Table 1.1:
Albania - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	3.7	2.5	1.4	1.1	2.1	2.7
Private consumption	Ann. % ch	1.7	1.8	0.7	1.8	3.4	-2.3
Gross fixed capital formation	Ann. % ch	4.0	0.7	0.5	1.2	-2.2	15.7
Unemployment rate	%	13.7	13.4	13.8	16.4	17.9	17.3
Employment	Ann. % ch	-0.1	2.3	18.5	-9.7	1.6	7.7
Wages, public sector	Ann. % ch	6.7	7.0	7.3	4.1	1.7	2.3
Current account balance**	% of GDP	-11.3	-13.2	-10.2	-10.9	-12.9	-11.6
Direct investment (FDI, net)**	% of GDP	9.3	6.6	6.8	9.6	8.2	9.0
CPI, average	Ann. % ch	3.6	3.5	2.0	1.9	1.6	1.9
Exchange rate LEK/EUR	Value	137.79	140.33	139.04	140.26	140.14	140.43
General government balance	% of GDP	-3.1	-3.5	-3.4	-5.0	-5.2	-0.6
General government debt	% of GDP	57.7	59.4	62.1	65.5	70.2	70.4

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

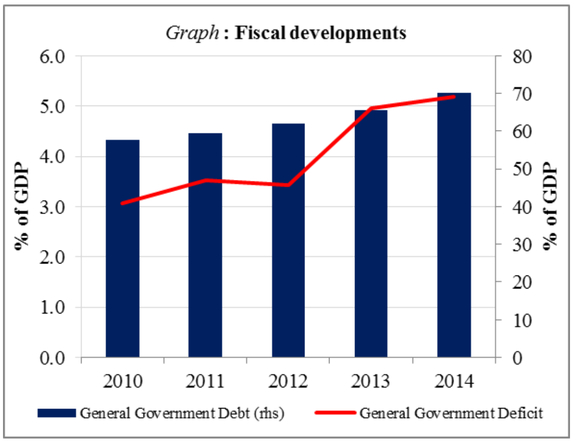
Unemployment remained high despite an increase in employment. Employment, in line with the economic recovery, grew by 1.6 %, but due to a rise in the labour force the unemployment rate rose from 15.9 % to 17.5 % in 2014 as a whole, before falling to 17.3 % in the second quarter of 2015. 56.6 % of the working-age population were employed in 2014, almost unchanged from 2013. However, the high prevalence of long-term and youth unemployment and large gender differences in labour force participation indicate significant structural obstacles. Nearly a third of the employed are unpaid family workers (mainly in agriculture) and informal employment remains widespread; this affects job security and social security entitlements and hinders company development. Some progress was made on strengthening labour market policies in line with the national employment and skills strategy for 2014-2020, adopted in November 2014. However, more needs to be done to improve the functioning of the national employment service, strengthen employment promotion programmes, modernise training services and develop a coherent labour market information system.

Inflation remained weak, allowing the central bank to lower the key interest rate. Average annual inflation remained below the Bank of Albania’s (BoA) 3 % target in both 2013 (at 1.9 %) and 2014 (at 1.6 %). This resulted from below-potential economic activity, low inflation in trading partners and a stable exchange rate against the euro. In the first seven months of 2015, inflation was volatile as a result of floods temporarily disrupting agricultural production and driving up food prices; however, on average it remained well below the target rate. Persistently low inflation allowed the BoA to bring down the key interest rate in several steps to a new historic low of 2 % in January 2015 in an effort to stimulate economic activity and steer inflation towards the target. The BoA was successful in lowering market interest rates and supporting credit growth, even if banks’ increased risk aversion hampered the pass-through of monetary stimulus to the economy. The degree to which the financial system uses the euro (‘euroisation’) lessened but remains high. This entails credit risks in case of abrupt changes in the exchange rate and reduces the room for manoeuvre for monetary policy.

The budget performed well in 2014, but revenues fell short of the target in the first half of 2015. The 2014 deficit outcome, at 5.2 % of estimated full-year GDP, remained well below the initial target of 6.6 %. Revenues increased by 12.1 %, resulting from tax increases and successful efforts to improve tax collection. At the same time, total spending was 3.9 % lower than budgeted due to underperforming public investment and operational expenditure. In 2014 the budget also had to finance the repayment of government arrears to businesses, amounting to 2.4 % of GDP. Without this extraordinary expense, the budget actually posted a small primary surplus for the first time since 2010. In the first half of 2015 tax revenues fell short of targets mainly due to overoptimistic assumptions about revenue

> **ERP recommendation 1:** ‘Pursue fiscal consolidation in line with the objective to put the public debt ratio on a downward path and lower it to less than 66 % of GDP by 2017. At the same time, preserve fiscal space for growth-enhancing public investment by making sure that revenue performance remains on track, allowing for the initially budgeted capital expenditure to be executed.’

growth, lower-than-expected inflation, and the fall in oil prices. The budget was revised in July and revenue targets were lowered, but thanks to savings on interest payments and substantial underspending on investment, the overall deficit target was left unchanged at 4 % of GDP (which includes repayment of arrears worth 1.3 % of GDP). Over-optimistic projections for tax revenue and investment spending are recurring problems that need to be tackled



The high level of public debt, almost half of it short-term, remains a key source of macroeconomic risk. Public debt increased significantly to 71.8 % of GDP in 2014 from 55.1 % in 2008 in the wake of the economic slowdown. The large proportion of short-term debt translates in debt equivalent to about 20 % of GDP needing to be rolled over every year, relying mainly on domestic banks, which creates refinancing risks. Accordingly, the stated objective for 2015 and beyond is to continue fiscal consolidation and reduce public debt, in accordance with ERP recommendation 1. This would not only help rebuild fiscal buffers to fight any future downturn, but also foster financial stability given large holdings of government debt by banks.

An ambitious pension reform has largely been implemented with the aim of improving the long-term sustainability of the system. The government made some progress in addressing fiscal risks stemming from the electricity sector. This public utilities sector is characterised by very high distribution losses and inadequate bill collection, which leads public finances to bear the costs, including those of emergency imports of electricity. While the government has already taken measures to clamp down on electricity theft and illicit connection to the grid, sustained efforts are needed to make the electricity sector financially sustainable, in line with ERP recommendation 2.

ERP recommendation 2: 'Progress towards eliminating high fiscal risks posed by the electricity sector by reducing distribution losses at an average rate of 5 percentage points in the coming years and by improving the bill collection rate. Evaluate the fiscal impact of the property compensation scheme and accommodate the costs in the medium-term budget, if necessary by adjusting the parameters of the scheme with the aim of creating a realistic, transparent and sustainable compensation framework.'

Additional fiscal risks include the obligation for the state, confirmed by judgments of the European Court of Human Rights, to pay compensation to former owners of property confiscated during the communist regime. In line with ERP recommendation 2, Albania prepared a draft law which would improve the financial sustainability of the current compensation scheme.

The budget management framework needs to be significantly strengthened, in accordance with ERP recommendation 3. Shortcomings in public finance management (PFM) include weak budget planning and monitoring, over-optimistic growth and revenue projections, as well as lax tax collection especially in election years. Over the years, these shortcomings have contributed to increased public debt and large government arrears to the private sector. To address these weaknesses, the government approved an ambitious PFM strategy for the period 2014-2020, supported by the Instrument for Pre-Accession Assistance (IPA). It contains plans to strengthen multi-year budgets, introduce rules to limit politically motivated ad hoc spending increases and eliminate systematic biases in budget forecasts. Fiscal credibility is to be reinforced by adopting a fiscal rule the details of which have yet to be worked out.

> **ERP recommendation 3:** 'Reinforce the budget management framework by implementing the public finance management strategy agreed with the Commission and adopted in December 2014, in particular by moving towards adopting a credible fiscal rule which will effectively ensure the sustainability of public finances in the long run and by strengthening budget forecasting.'

Interplay of market forces

Market liberalisation and privatisation are advanced. Price and trade liberalisation was carried out early in the transition process and privatisation is wide-ranging. The state's involvement in the economy remains limited and is concentrated in a few sectors such as energy. The private sector remains dominant, accounting for more than 80 % of the workforce. Privatisation efforts are now focused on state-owned small and medium-sized enterprises (SMEs) in non-strategic sectors. Some companies with poor economic performance went into liquidation in the reporting period, while the unused assets of others were offered for lease to domestic and foreign investors. In addition, a decision was made to privatise the state insurance company INSIG through an open tender that attracted four bids. A working group has been set up to identify the best option for restructuring and privatising the oil company Albpetrol.

Market entry and exit

Further improving market entry and exit procedures could facilitate the efficient allocation of resources. Business registration continues to function reasonably well through the established network of the national registration centre (NRC). The number of start-ups surged by 43 % in 2014 and reached a six-year high, and business registrations have continued to increase in 2015, partly reflecting efforts to formalise the large informal economy. Plans to further streamline procedures by merging the NRC with the licensing authority to create a single service window for registration and licensing should be implemented in line with ERP recommendation 6. Steps have also been taken to create an inventory of authorisations to remove unnecessary ones. Firms' access to formal finance, especially in the start-up phase, remains a challenge. Bankruptcy procedures remain slow and the recovery rate for debtors in most cases turns out to be low. There was some progress on revising the bankruptcy law.

> **ERP recommendation 6:** 'Improve the overall business environment, including by implementing the merger of the NRC (National Registration Centre) and NLC (National Licensing Centre) to further ease the regulatory and administrative burden for businesses. Start the implementation of the simplification regime for authorisations. Make the newly established investment council fully operational.'

Legal system

There are significant shortcomings in the rule of law, property rights enforcement and the fight against corruption which remain key aspects to improving the business environment. Steps have been taken to address these complex challenges *(see Chapter 23 — Judiciary and fundamental rights)*, but much remains to be done. Efforts were also made to improve the government's communication with businesses, notably by setting up an investment council and requiring mandatory consultation of stakeholders on new legal drafts, and to reduce the regulatory burden on businesses. However, results have yet to materialise.

Financial sector development

There is scope for banks to expand lending and better support the economic recovery. The banking sector, dominated by foreign-owned banks, holds 90 % of all financial system assets. With loans to businesses and households amounting to less than 40 % of GDP, there is much scope for increasing the role of bank lending in the economy. However, credit growth has only started to gather some momentum towards the end of 2014, despite banks' ample liquidity and the gradual fall in credit rates. While the economic slowdown has reduced the demand for loans, the high proportion of non-performing loans (NPLs), which peaked at 24.9 % in 2014 and was still 21 % in June 2015, has contributed to banks' increased risk aversion and cautious lending. Various regulatory and legislative changes have already been made to address the problem, and an inter-institutional working group was set up to develop a comprehensive NPL reduction strategy. However, in line with ERP recommendation 4, further efforts are needed to encourage the clean-up of bank balance sheets and boost lending, including by addressing impediments to judicial enforcement and collateral execution.

The banking system appears stable but is exposed to credit and sovereign debt risks. Overall, the capital and liquidity ratios of the banking system well exceed regulatory minima, and profitability was improving in 2014 and the first half of 2015. The three Greek-owned banks operate as stand-alone subsidiaries with adequate capital and liquidity buffers and no significant exposure to their parent banks. The central bank put in place additional prudential measures following the introduction of capital controls in Greece: therefore, financial contagion risks seem well contained. Banking activity continued to be fundamentally financed by deposits, with the loan-to-deposit ratio standing at around 55 %. Provisioning for potential losses on non-performing loans improved, but NPLs net of provisions still amounted to 36 % of bank capital in July. Banks are also exposed to credit risks originating from foreign currency loans whose repayment is vulnerable to a potential depreciation of the Albanian currency (lek). Also, since government securities make up around a quarter of bank assets, severe sovereign debt stress would be detrimental to banks' solvency.

> **ERP recommendation 4:** 'Take further measures to address the issue of non-performing loans, involving all key stakeholders including the Bank of Albania as necessary, with a view to achieving a sustainable reduction of their level. In this context, addressing impediments related to judicial enforcement and collateral execution would appear helpful.'

The size of the non-banking financial sector increased but remains small. It comprises the insurance and private pension businesses plus investment funds; total assets represent 6.5 % of GDP. The regulatory and supervisory framework for the sector needs further strengthening. The capital market remains rudimentary. There is great scope for expanding equity finance.

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

> Albania has **some level of preparation** in terms of capacity to cope with competitive pressure and market forces within the Union. **Some progress** was made particularly as regards transport and energy infrastructure. However, significant investment in human and physical capital is necessary to improve the country's competitiveness. There is considerable scope for shifting employment to more

productive sectors and for diversifying export products and markets. In line with the ERP recommendations and in order to support long-term growth, in the coming year Albania should pay particular attention to:

→ improving the quality of higher education and continuing the restructuring of vocational education and training to improve its market relevance;

→ adopting and implementing the national transport and energy strategies;

→ lowering non-tariff barriers to trade.

Human and physical capital

ERP recommendation 5: 'Adopt and start to implement the law on higher education, as well as the new strategy for higher education. Establish an independent accreditation system for all public and private universities. Continue the restructuring of the vocational education and training system with a view to improving the relevance of the training for the needs of the labour market.'

Despite significant improvements over the last decade, Albania still has considerable gaps to close in terms of years of schooling, secondary enrolment rates, education quality and the market relevance of qualifications. Public spending on education remains low at around 3 % of GDP and is expected to fall slightly in 2015 due to lower budgeted investment spending in this area. Albania adopted and started to implement the national employment and skills strategy for 2014-2020. Institutional changes are expected to be followed by the introduction of an apprenticeship system and upgrades to the curricula in line with market needs. In line with ERP recommendation 5, this should remain a priority, along with drafting a new strategy on higher education and setting up a new accreditation system for universities. Low scores received by Albanian students in the OECD's PISA tests underline the need for improving the quality of basic education (*see also Chapter 26: Education and culture*).

Improving physical capital and promoting innovation are important elements for enhancing productivity and competitiveness. Investment as a share of GDP decreased from 33.9 % in 2008 to 24.9 % in 2014, driven by weak investment in construction and in machinery and equipment. With some large foreign direct investment projects in the energy sector under way, including the construction of a large hydropower plant and the Albanian section of the Trans-Adriatic Pipeline, investment is likely to rebound in the coming years. Still, a more favourable investment climate is needed to attract capital into a wider range of sectors. New laws were adopted in May with the aim of promoting investment in strategic sectors and developing economic zones through lowering administrative burdens and providing fiscal incentives for such projects. Public investment made up 5.1 %-5.5 % of GDP in past years, but was often the target of ad hoc spending cuts when budget adjustments were needed. Public spending on research and development continued to represent only 0.01 % of GDP and much remains to be done to develop an innovation culture and links between science and industry.

> **ERP recommendation 7:** 'Adopt and start to implement the transport strategy and action plan for 2016-2020. Focus investments on the core network. Adopt and start to implement the national energy strategy and the Power Sector Law, including speeding up the unbundling of the energy sector. Prepare single sector pipeline of priority investments for both transport and energy.'

While progress has been made over the years, Albania's transport and energy infrastructure is still not sufficiently developed. The finalisation and implementation of the transport strategy 2016-2020 are expected to improve overall transport infrastructure in the country and are highlighted as a priority in ERP recommendation 7. Focusing investment on the core network, in particular, would improve connectivity within the Western Balkans as well as with the EU.

Sectoral and enterprise structure

> **ERP recommendation 8:** 'Adopt a strategy on the land cadastre and concrete measures to increase momentum in agricultural land consolidation.'

The Albanian economy is dominated by services, and agriculture still plays an important role. In 2014, services accounted for around half of gross value added, unchanged from 2008, followed by agriculture with a share of 22.6 %. Industry's role has increased over the last years (making up 14.2 % of the economy in 2014, up from 11.4 % in 2008) due mostly to increased oil extraction. At the same time construction's share of the economy fell to 11 % in 2014 from 18 % in 2008 following the economic crisis and the slowdown in lending. Agriculture provides a gradually falling, but still very large, proportion of employment (around 42.7 % in 2014), much of which is in the form of unpaid family jobs. In line with ERP recommendation 8, a strategy on the land registry (cadastre) should be adopted.

The sectoral composition of merchandise exports remained highly concentrated, with 82 % of total exports in 2014 accounted for by mineral products (33.6 %), textiles and footwear (33.6 %) and construction materials and metals (14.5 %). This lack of diversification contributes to the large external deficit and exposes the economy to industry-specific shocks.

Small and medium-sized enterprises (SMEs) play a significant role in the economy. They provide 81 % of employment and 70 % of value added in the non-agricultural private sector. Micro-businesses in particular make up a high proportion of the number of companies and account for 46 % of jobs. Various state and donor-funded schemes support SMEs' competitiveness and access to finance. The business development and investment strategy 2014-2020 has made support services for SMEs and start-ups a priority. Besides putting this strategy into action, further efforts could be made in implementing an SME test to ensure that regulations and legislation do not impede SME development and growth.

State influence on competitiveness

Reported state subsidies to the economy remained relatively low, but the electricity sector is an enduring drain on public resources. Total reported state aid stood at 0.5 % of GDP in 2014, marking a considerable decrease from 1.5 % in 2013. Around two-thirds of the subsidies were notionally granted for less distortive general business purposes, such as research and development and employment. However, much of the general business aid continued to benefit certain industries, such as the hydrocarbon or the clothing industries. Data on state aid does not include loan guarantees granted to the state-owned power company KESH to ease its financial difficulties. There is scope for improving the enforcement of competition rules.

Economic integration with the EU

The EU is Albania's dominant trading partner, with especially strong links to Italy. Albania has increased its openness to trade, with total imports and exports rising to 92.3 % of GDP in 2014 from 86 % in 2008. The EU remains Albania's largest trading partner by far, with a share of 77.4 % of its goods exports and 61.1 % of its goods imports in 2014. Italy is the main destination for Albanian exports, absorbing more than half of Albanian goods sold abroad in 2014 and providing almost a third of its goods imports. Trade links with Central European Free Trade Agreement (CEFTA) countries are also relatively important as they accounted for some 12 % of Albanian goods exports and 8 % of its imports of goods in 2014, but these shares are largely unchanged since 2008, pointing to a potentially large untapped potential for future growth.

Substantial progress has been made in lowering technical barriers to trade. However, additional efforts should be made in the area of sanitary and phytosanitary measures and administrative barriers, such as introducing electronic clearance of goods and streamlining customs procedures.

1.3. CONCLUSIONS

As regards the economic criteria, Albania is moderately prepared in developing a functioning market economy. Some progress was made in improving macroeconomic stability and growth prospects improved. Inflation remained low. However, significant challenges remain. Further efforts are needed to sustain fiscal consolidation, improve the business environment and tackle the informal economy. Albania should also improve the budget management framework and address the high level of non-performing loans. The levels of unemployment (17.5%) and informal employment remain high.

Concerning the capacity to cope with competitive pressure and market forces within the Union, Albania has some level of preparation. Some progress was made as regards education, transport and energy infrastructure. However, significant investment in human and physical capital is necessary to improve Albania's competitiveness. Albania should improve the quality of higher education and continue restructuring the vocational education and training, adopt and implement the national transport and energy strategies and lower non-tariff barriers to trade such as shortcomings in food safety.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The Monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process. In order to improve their economic governance, in 2015 the enlargement countries were asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The former Yugoslav Republic of Macedonia has **a good level of preparation** in developing a functioning market economy. Overall, **no progress** was made. On the one side positive developments were recorded particularly as regards the business environment. The macroeconomic environment strengthened further, despite key vulnerabilities. However, this was counterbalanced by backsliding in the management of public finances. The government continued to promote growth and employment through major public infrastructure investment and foreign direct investment (FDI). This contributed to improving the structure of exports and job creation. However, the development of a competitive private sector remained hampered by weak contract enforcement and the large informal economy.

In line with the 2015 ERP recommendations and in order to support long-term growth, the former Yugoslav Republic of Macedonia should pay particular attention to:

→ improving medium-term budget planning and execution, and adhering more rigorously to the medium-term fiscal strategy;

→ continuing with structural reforms to improve the business environment and establishing an efficient bankruptcy procedure;

→ taking further measures to repair the bank lending channel.

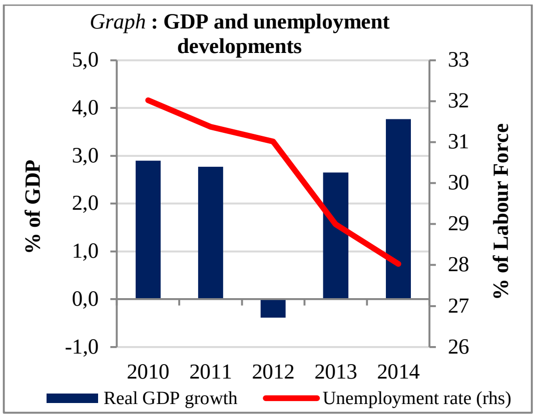
Economic policy essentials

The government remained committed to pursuing market-based economic reforms, attracting FDI and developing the private sector. In January 2015, the authorities submitted their Economic Reform Programme (ERP), outlining key economic, fiscal and structural reforms and policies for 2015-2017. The government has made little progress on structural reforms of the labour market and there was even backsliding on fiscal discipline. Efforts to strengthen medium-term budget planning and execution and the employability of workers should therefore be strengthened. The government should take further measures to implement the ERP recommendations, which are set out below.

The government continued to engage actively with the international financial institutions. In November 2014, the IMF concluded its fourth and last post-programme monitoring mission related to the country's 2011-2013 precautionary liquidity credit line. In February 2015, the government repaid in advance all outstanding loans to the IMF.

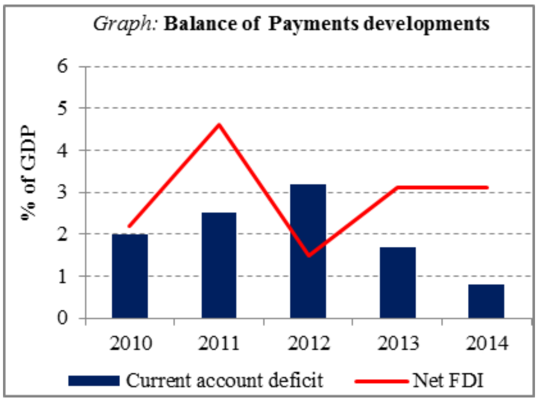
Macroeconomic stability

The macroeconomic environment strengthened further, but key vulnerabilities remained a source of concern. The economic recovery continued, with domestic demand becoming the sole driver of growth. Output expanded by 3.8 % in 2014 and solid growth continued in the first quarter of 2015. Investment picked up markedly in 2014 due to public road, rail and energy infrastructure projects and new FDI. Import demand, mainly investment-related, increased accordingly.



The recovery of industrial production from its 2012 trough continued, driven by the manufacturing sector, which accounts for about three quarters of industry, although performance in the first quarter of 2015 disappointed. Overall, sustainable development of the economy can only be achieved if the domestic private sector continues to develop and contribute more to growth.

The stability of the external sector relied increasingly on public borrowing abroad. The current account deficit has declined steadily since 2009 and stood at a moderate 0.8 % of GDP in 2014. This development has been driven by an improvement in the merchandise trade balance, spurred largely by exports made by foreign investors in the automotive components sector. Current transfers from abroad fell, but remained significant. FDI inflows (3.3 % of GDP) remained markedly below their 10-year average (4.3 % of GDP). External debt stood at 70 % of GDP at the end of 2014, up by more than 5pp from a year earlier, mainly due to an increase in public debt and, somewhat less, in FDI-related intercompany lending. Hence, movements in foreign exchange reserves were increasingly driven by public borrowing abroad, rather than by private investment.



Risks to the domestic economy from the economic situation in Greece, via trade, investment and financial linkages appear limited at this point. The share of Greece as a destination of the country's exports has fallen from 10 % in 2008 to 5 % in 2014, yet fuel imports have risen markedly. In the medium term, a sustained crisis in Greece may, however, impact on the economy through a protracted loss in consumer and investor confidence, lower exports and more costly external government financing.

Labour market conditions remained burdened by structural impediments. The unemployment rate has steadily fallen since 2008 (34 %), to 28 % in 2014. Significant gender differences persist with economic activity rates of women being considerably lower than those of men (56.8 % compared to 84,5 % for 2014). Job creation returned to average speed in 2014 after a surge in 2013. New jobs were created mainly in low-productivity sectors and agriculture, supported by public subsidies and active labour market measures. It is estimated that the public sector accounts for 20 % of total employment. **Prices remained stable; monetary policy successfully defended the currency peg.** Lower prices for food and for energy contributed to a fall of 0.3 % in the consumer price index (CPI) in 2014.

Annual average inflation has steadily decreased since 2011, when it stood at 3.9 %. Since April 2015, headline inflation has registered positive gains again. The central bank kept the key policy rate unchanged in 2014.

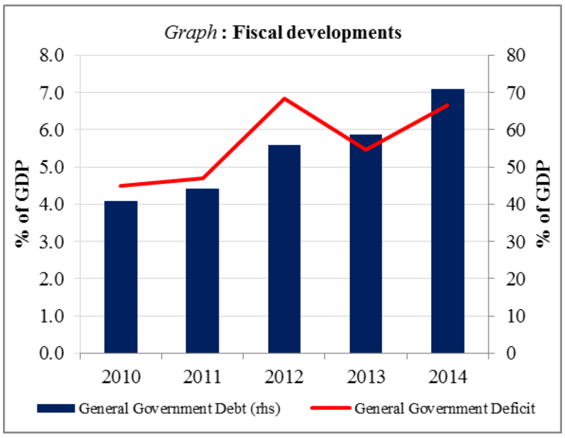
Table 2.1:
The former Yugoslav Republic of Macedonia - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	2.8	3.0	-0.5	2.7	3.8	2.9
Private consumption	Ann. % ch	2.3	7.4	1.2	2.1	2.3	2.1
Gross fixed capital formation	Ann. % ch	-4.3	15.7	21.2	-16.8	15.2	-3.2
Unemployment rate	%	32.1	31.4	31.0	29.0	28.0	27.1
Employment	Ann. % ch	1.3	1.1	0.8	4.3	1.7	1.7
Wages	Ann. % ch	0.9	1.3	0.2	1.2	1.0	2.7
Current account balance**	% of GDP	-2.0	-2.9	-3.2	-1.7	-1.3	0.3
Direct investment (FDI, net)**	% of GDP	2.2	4.6	1.7	3.3	3.3	2.2
CPI, average	Ann. % ch	1.6	3.9	3.3	2.8	-0.3	-0.3
Exchange rate MKD/EUR	Value	61.51	61.53	61.53	61.58	61.62	61.59
General government balance	% of GDP	-2.4	-2.5	-3.8	-3.9	-4.2	-3.7
General government debt	% of GDP	24.1	27.7	33.7	34.2	38.2	36.1

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

Fiscal discipline slipped again in 2014 and 2015, pointing to a need to improve medium-term expenditure planning. The government adopted a supplementary budget in autumn 2014, due both to revenue shortfalls and to earlier and higher-than-expected expenditure on infrastructure. The supplementary budget revised the deficit target upwards, from 3.4 % to 3.6 % of GDP. However, the actual budget deficit was even higher, at 4.2 % of GDP, on account of ad hoc increases in spending on pensions, social benefits and subsidies, as well as additional resources required for the construction of the Corridor X motorway.

ERP recommendation 1: 'Improve the management of public finances by adhering rigorously to the 2015-2017 medium-term fiscal targets outlined in the ERP, and frontload consolidation so as to be on track for the 2017 budget deficit target of 2.9% of GDP. Use any additional fiscal space for further consolidation measures, so as to protect growth-enhancing capital spending in case of unexpected budget pressures. Keep tight control on the development of transfer payments, pensions, and public wages. Introduce a medium-term expenditure framework. Inform in a timely and regular manner on the size of the government workforce and payroll.'



In July 2015, the government adopted again a supplementary budget, raising expenditure in particular for social welfare assistance, police wages, and budgeted capital expenditure. The 2015 deficit target was raised from 3.4 % to 3.6 % of GDP despite increased revenue projections. GDP growth expectations reduced for 2015, by 0.5pp to 3.5.

The composition of public spending did not improve. In 2014, investment accounted for only 10 % of the budget and even less of actual spending. Some 45 % of total spending went on social transfers including pensions, which the government had increased, as in the previous year, beyond what was required by law and despite falling prices. Public sector wages and agricultural subsidies were also raised beyond statutory requirements in 2014.

ERP recommendation 2: 'Improve the composition of spending, by prioritising investment projects according to their productive potential, and be more transparent on the cost-benefit analysis underlying transfer and investment spending items on the budget. Provide more timely and detailed data on planned and executed capital expenditure.'

The government's commitment to the medium-term fiscal strategy weakened - the 2015-17 strategy provides for a gradual decline in the general government deficit to 2.9 % of GDP by 2017, relaxing the previous target of 2.6 %. Given the 2015 supplementary budget, and in anticipation of a further increase in entitlement spending in the upcoming pre-election period, reaching the 2017 target seems overly ambitious. Overall, the link between the medium-term framework and the annual budget process remains weak, leading to further retrenchment of fiscal space needed to absorb unexpected spending pressures or revenue contraction.

Public debt levels have risen markedly in recent years and amendments to the public debt law raise concerns about transparency. The general government debt ratio is still comparatively moderate, but has been rising continuously since 2008. The increasing financing needs of state-owned enterprises, which carry out major infrastructure works, have contributed to a marked rise in overall public debt, which stood at 46 % of GDP at the end of 2014, compared with 38.6 % at the end of 2013. This is likely to rise further in the short to medium term, given the scale of planned investment projects. In the summer of 2014, the government amended the public debt law to restrict the scope for borrowing by state-owned enterprises with state guarantees, while encouraging non-guaranteed borrowing. As a result, the public debt figure will be less transparent. The government should improve the management and the transparency of public finances, practise more rigorous fiscal discipline and improve fiscal transparency as recommended in ERP recommendations 1, 2 and 3.

ERP recommendation 3: 'Improve the fiscal transparency by including more comprehensive data on the debt of public companies and contingent liabilities in the government's debt management strategy and inform about arrears. Speed up transition to ESA 2010 reporting and resume fiscal notifications. Continue to keep tight control on guaranteed and non-guaranteed borrowing by state-owned enterprises and municipalities.'

Interplay of market forces

The public sector's share of the economy remained largely unchanged. In 2013, the government sold its minority stake in two companies. However, the number of fully state-owned enterprises remained unchanged at 15. In January 2013, the Public Enterprise for State Roads (PESR), which is state-owned, started operations. In October 2014, the government decided to postpone full liberalisation of the electricity market, planned on 1 January 2015, for five years. Administered and regulated prices accounted for some 15 % of the CPI basket. Most are regulated prices that usually cover production costs. Electrivity prices for households and small companies as well as prices for natural gas and oil remain subject to regulation by the Energy Regulatory Commission (ERC).

Market entry and exit

Setting up a business became slightly easier, but market exit remained cumbersome. The implementation of measures under the 'regulatory guillotine' project progressed further, with a view to facilitating business registration. However, the 'one-stop-shop' procedure is advancing only slowly. Conditions for obtaining public support and administrative fast-track procedures implicitly favour (bigger) foreign firms, as local firms can rarely meet the investment size criteria. Connections between the more technologically advanced foreign companies and the domestic private economy are poor, which is a particular concern. Progress in simplifying market exit is more limited; the bankruptcy law was amended to shorten procedural deadlines and allow out-of-court settlement in the event of insolvency.

Legal system

Frequent legal changes, uneven implementation of laws and difficult contract enforcement burdened business operations. Since 2011, the government has adopted a number of judicial reforms to speed up procedures and improve capacity, e.g. by upgrading information and electronic delivery systems, which accelerated certain court procedures and improved the handling of backlog cases. No major new reforms were undertaken in 2014 and beyond. Protection and enforcement of intellectual property rights remain a concern. The large informal economy continued to hamper competition and private sector development. The Labour Ministry regularly updates its action plan on reducing the shadow economy, but the indicators and measures presented are not fully coherent, and there is no results-based assessment of previous measures. Government arrears still affected domestic companies' liquidity, despite the recent adoption of the Law on Payment Discipline. The business environment should be improved in accordance with ERP recommendation 8.

ERP recommendation 8: 'Improve the business environment by implementing the Master Plan for Competitiveness and the related Government Action Plan. These should include measures affecting competitiveness, such as a more predictable legal and regulatory environment, enforcement of contracts, respect of IPRs, payment discipline, labour legislation, quality and integrity of inspection services, etc. Ensure regular and structured dialogue with social partners regarding the implementation and review of the Master Plan. Step up efforts to fight against corruption and informalities in the economy.'

Cooperation between the government and the business sector has declined in recent years. The proportion of draft laws published on the electronic register (ENER) fell significantly over recent years, and the number of laws that undergo frequent changes or are adopted with too short consultation deadlines has increased. In many cases, there is little ex post consultation with stakeholders on the laws' impact and effectiveness once they have been implemented (see also political criteria – Policy development and co-ordination).

Financial sector development

The banking sector remained stable despite high levels of non-performing loans (NPL). The financial sector remains dominated by banks which account for roughly 90 % of the financial system's total assets. Foreign ownership of banking assets remains high, at about 70 %, and concentration levels have not declined much over recent years – the three biggest banks hold 60 % of the sectors assets, compared to about 66 % in 2010. The main funding source of banks are deposits, which have kept growing since 2013. Financial stability indicators, such as regulatory capital ratios, point to the system's continued resilience. Profitability improved in the second half of 2014, after a lacklustre performance in the preceding two years partly due to the high share of bad loans. Since 2013, the central bank has managed to gradually reduce the share of outstanding loans denominated in foreign currency, hence decreasing exchange rate risks. Further measures should be taken to implement ERP recommendation 6.

ERP recommendation 6: 'Increase efforts towards facilitating the disposal of non-performing loans by banks, involving all key stakeholders including the central bank as necessary, with a view to removing potential obstacles to credit extension in the context of a sustained pick-up in credit demand.'

Roughly one fifth of the domestic banking sector's assets and liabilities are held by two subsidiaries of Greek banks. Both are financially sound and their funding is assured mainly through domestic deposit-taking. In addition, the central bank put in place prudential measures aimed at containing possible repercussions from the banking crisis in Greece. As a temporary emergency measure, it also prohibited residents from exporting capital related to capital transactions such as debt and equity purchases and long-term lending to Greece.

Liquidity in the banking sector remained ample in 2014 and beyond, and bank lending to the private sector continued to rally. While lending to non-financial companies picked up noticeably, these funds were used mainly for working capital purposes, rather than for new investment. The ratio of non-performing to total loans to the non-financial sector remained elevated, at 11.5 %, at the end of the second quarter of 2015, and only somewhat lower than a year earlier. The ongoing establishment of a modern and comprehensive land registry (cadastre) is expected to help inform lenders about the value of real estate as collateral. The setting up of a private and public credit registry should also boost the quality of lending.

ERP recommendation 9: ‘Improve access to finance for SMEs and speed up bankruptcy procedures. Continue with the implementation of the innovation strategy, and step up the use of instruments foreseen by the Innovation Fund.’

Bank lending remains by far the dominant form of company financing, with the development of a wider financial market stalled - equity financing by public listing has even declined in recent years. To support the restoration of credit flows, the government should take further measures to facilitate the write-off of bad claims. To improve access to finance for companies under ERP recommendation 9, the government should support the development of venture capital and equity financing, leasing and factoring, among other measures.

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

The economy is moderately prepared to cope with competitive pressures and market forces within the Union. Some progress was made particularly as regards addressing prevalent shortcomings in human capital and physical infrastructure. However, businesses remained concentrated in low-productivity activities and it is necessary to increase the value added in productive sectors. Further investment is needed to boost labour productivity growth and speed up the transformation of the economy. Overall, the state’s influence on competitiveness increased.

In line with the 2015 ERP recommendations and in order to support long-term growth, the former Yugoslav Republic of Macedonia should pay particular attention to:

→ improving the employability of workers by better aligning education with labour demand needs, and improving the basic and transversal skills of students at all levels of education;

→ upgrading linkages between foreign direct investors and the economy and encouraging investment in capital goods and innovation;

→ better prioritising investment and aligning the transport strategy with the regional agenda on connectivity.

Human and physical capital

The share of highly qualified workers in the economy is rising, but structural factors limit an increase in labour productivity. Recent reforms have led to greater participation in education. The number of early school leavers has dropped and pre-school enrolment has increased in the past three years. The overall proportion of tertiary education graduates in the workforce rose by 4 % to 18 % of the workforce between 2009 and 2013. However, one quarter of university graduates were unemployed, as most new jobs were concentrated in low-productivity sectors.

The main challenges remained the low labour market participation (particularly among women), skills mismatches, and limited job opportunities in advanced industrial sectors. Hence, labour productivity has remained at around 18 % of the EU average for a number of years. The structure of employment remained focused on low-productivity sectors, and agriculture (19 % of total employment). The government continued to address labour market challenges primarily through a wide variety of active measures, including an array of employment subsidies to incentivise recruitment. These measures did not adequately address the underlying structural causes of unemployment, and were not sufficiently subjected to performance evaluations. This weakened their impact. Implementation of the 2013-2020 vocational education and training strategy is lagging behind in many areas. Several measures have been adopted, but their effectiveness is insufficiently monitored. Overall, worker employability could be improved by following ERP recommendation 4. To achieve marked improvements in labour productivity, the education system would benefit from closer ties between education programmes and employers, including foreign investors operating in higher value added sectors.

> **ERP recommendation 4:** 'Improve the employability of workers, by better aligning skills with labour demand needs notably by developing the education system. Strengthen performance evaluations of active labour market policies with a view to better targeting skills development, and inform on their methodology and results in a timely manner.'

Public infrastructure is in need of modernisation. The state of transport and energy infrastructure continued to hamper economic development. The government is addressing this challenge through large-scale public investment projects. As a result, total investment volumes rose sharply in 2013 and again in 2014, with public projects accounting for about one fifth of total investment in the manufacturing and construction industries.. It makes it all the more important to base the development of infrastructure on a reviewed transport strategy aligned with the regional agenda on connectivity, in accordance with ERP recommendation 7.

Private sector investments remained subdued. Domestic firms did not sufficiently invest in the renewal of their capital assets and in innovation. As a result, there is an emerging dichotomy in the country's capital stock, with foreign investment increasingly focused on higher-productivity, technology-intensive sectors (mostly concentrated in special economic zones), while capital stock in the local economy remains low and relatively outdated.

> **ERP recommendation 7:** 'Review the transport strategy in order to align it with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network) and establish a credible planning and funding mechanism. A single sector pipeline would help prioritise investments.'

Sectoral and enterprise structure

The sectoral structure of the economy remained largely stagnant. Manufacturing contributed some 12 % to gross value added in 2014, the same as in 2009. Agriculture's share of the economy declined only slightly during that period, to 10 %, while trade and services increased by 4.5 % and contributed almost half of the country's value added. The structure of business also remained largely unchanged, with micro-enterprises and small businesses accounting for more than 98 % of all companies. However, in the last three years, the number of large companies has more than doubled, mainly due to foreign investment, although their share remained below 1 %. SMEs provided the bulk of jobs (80 % of total employment). The sectoral structure of the economy would benefit from following ERP recommendation 5.

> **ERP recommendation 5:** 'Step up efforts to create supply linkages between foreign and domestic companies with a view to enhancing productivity and employment in the domestic economy.'

State influence on competitiveness

While the government's share of economic assets remained moderate, its influence on private sector competitiveness through regulations and subsidies is rising. The state's ownership of economic assets remained relatively moderate at about 15 % of GDP. However, the large share of state-owned land remained an obstacle to the development of the agricultural sector and to bank lending to companies and households, which is based on property as collateral. There is a wide range of policy instruments through which the government increasingly has an impact on the economy's competitiveness, such as direct subsidies and tax exemptions, in particular for foreign investors; unpredictable inspections of firms and sanctions; public guarantees for loans to state-owned enterprises; public infrastructure projects; and active labour market programmes. While the legal framework for state aid was strengthened in recent years, the information provided about the amounts and beneficiaries of state aid and about ex post evaluation has been limited.

Economic integration and convergence with the EU

Further progress was made in developing closer trade and investment links with the EU. Trade openness is relatively high given the state of economic development of the country. Trade in goods remained buoyant in 2014, at about 129 % of GDP. Exports rose by 5pp to 52 % of GDP, compared to a year earlier. The EU remained by far the most important trade partner in both exports and imports. In the first seven months of 2015, 77 % of total exports went to the EU, broadly stable from the same period in 2014, and 4pp higher than in this period in 2013. At 63 %, the share of the country's imports which originated in the EU also remained elevated.

With foreign investors increasing production, the structure of exports shifted somewhat towards products with higher value added — machinery and transport equipment exports accounted for 21 % of the total in 2014 (7 % higher than in 2013). Exports have diversified in recent years, but remain highly concentrated — iron and steel, metal ores, clothing and food accounted for about 40 % of all exports in 2014, compared with 56 % in 2010. EU companies are the main foreign direct investors in the economy. Their share of total FDI stock increased further in 2014, for the second year in a row, by 1.5 %, to 83 %.

2.3. CONCLUSIONS

As regards the economic criteria, the former Yugoslav Republic of Macedonia is at a good level of preparation in developing a functioning market economy. The country benefits from a stable macroeconomic environment, supported by sound monetary policy, favourable conditions for market entry, and a sound legal system. There was some backsliding in public finance management. Medium-term fiscal targets were relaxed, the composition of public spending remains tilted towards transfers and subsidies and the development of overall public debt, as well as its transparency, remain a concern. The budget should be more geared towards growth and employment, while its overall design, transparency and implementation should be improved. A high level of non-performing loans has constrained credit supply and needs to be addressed by further policy action. Unemployment remains high at 28%.

The economy is moderately prepared to cope with competitive pressures and market forces within the Union. There was some progress in diversifying the export structure as a result of direct investment; trade and investment links with the EU strengthened further. However, the country needs to improve the employability of people, in particular the youth, by better aligning education with labour market needs, upgrade linkages between foreign direct investors and the domestic economy, and better prioritise investment.

3. MONTENEGRO

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process. In order to enhance their economic governance, in 2015 the enlargement countries were invited to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework, together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro is moderately prepared in developing a functioning market economy. Some progress was made in addressing some economic challenges, in particular on fiscal consolidation and the business environment. The economy recovered in 2013 from the double-dip recession of 2009 and 2012. After a mild slowdown in 2014, economic growth is gaining momentum again, boosted by investments.

The construction of the Smokovac-Mateševo priority section of the Bar-Boljare highway as well as ongoing investments in energy, transport and tourism will support economic growth. However, challenges to macroeconomic stability remain. The cost of the highway risks challenging fiscal sustainability. Banks are confronted with problems of debt resolution and low profitability resulting in scarce and expensive credit. Further efforts are necessary to reduce the structurally high unemployment.

In line with the 2015 ERP recommendations and in order to support long-term growth, Montenegro should pay particular attention to:

→ sustaining its commitment to fiscal discipline and revising its public debt management strategy to reduce the public debt and to improve the sustainability of public finances;

→ addressing the high burden of non-performing loans (NPL) and improving the efficiency of contract enforcement;

→ amending labour legislation to introduce further market flexibility and better target active labour market policies as well as further improving the business environment.

Economic policy essentials

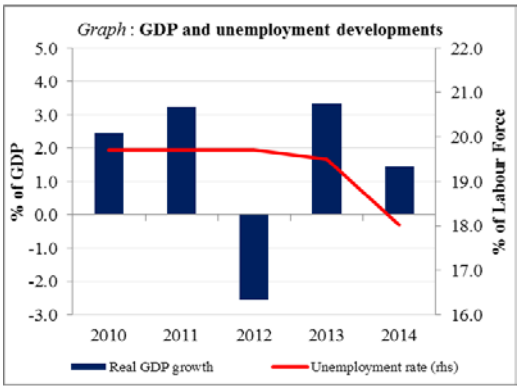
The government remained committed to pursuing market-based reforms, attracting FDI, and developing the private sector. In January 2015, Montenegro submitted its first Economic Reform Programme (ERP), covering the period 2015-2017. The ERP partially complied with the targeted policy guidance adopted by the Joint Ministerial dialogue of 6 May 2014.

ERP recommendation 1: "Sustain the commitment to fiscal discipline, establish a credible track record on the basis of the new rules-based fiscal framework and revise the public debt management strategy to bring the public debt into a downwards trajectory in line with the ERP medium-term framework. In this context, municipalities are also called to contribute by strengthening their own budgetary position. In order to improve transparency, develop the necessary administrative capacity to implement the European System of Accounts (ESA 2010)."

A number of major reforms still need to be implemented, including the ERP recommendations set out below. These include sustaining the commitment to fiscal discipline, implementing the voluntary bank loan restructuring programme, improving the business environment, and actively pursuing the reform of education to align it with labour market conditions.

Macroeconomic stability

The fast recovery after each recession episode is indicative of the Montenegrin economy's resilience to shocks. After suffering two recessions in 2009 and 2012, the economy recovered strongly in 2013, but moderated its pace in 2014. The economy has started to pick up speed again in 2015 boosted by a surge in public works and private investments, particularly in the transport, energy and tourism sectors. However, consumer spending and domestic investments have remained subdued, also due to banks' tight credit conditions, high unemployment and lower wages. The recessions marginally reduced the average per-capita income to 39% of the EU28 average in 2014, compared to 40% in 2013.



There has been no signficant improvement in Montenegro's trade deficit in the last four years. After a substantial decline in 2009, and a somewhat stronger export performance in 2010 and 2011, the trade deficit has since remained flat (at 40 % of GDP). The current account deficit widened in 2014 to 15.4 % of GDP and to 16.1 % of GDP in the four quarters to June 2015 on the back of a higher trade deficit and lower transfers from abroad. Net financial inflows consisted mainly of foreign direct investments (FDI), which remain above 10 % of GDP.

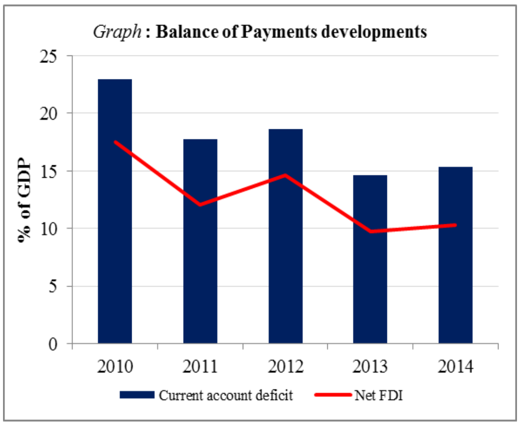


Table 3.1:
Montenegro - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	2.5	3.2	-2.7	3.5	1.8	3.3
Private consumption	Ann. % ch	2.0	0.5	-3.9	1.6	2.9	2.7
Gross fixed capital formation	Ann. % ch	-18.5	-7.2	-2.4	10.7	-2.5	19.6
Unemployment rate	%	19.7	19.7	19.7	19.5	18.0	18.0
Employment	Ann. % ch	-2.2	-6.1	2.2	1.1	7.1	2.5
Wages	Ann. % ch	11.0	1.0	0.8	-0.2	-0.3	0.3
Current account balance**	% of GDP	-22.8	-17.6	-18.5	-14.5	-15.2	-16.0
Direct investment (FDI, net)**	% of GDP	17.4	11.9	14.5	9.6	10.2	10.8
HICP, average	Ann. % ch	0.5	3.3	4.0	1.8	-0.5	0.9
Exchange rate EUR/EUR	Value	1.0	1.0	1.0	1.0	1.0	1.0
General government balance	% of GDP	-4.8	-4.9	-5.8	-6.4	-3.0	-5.9
General government debt	% of GDP	40.7	45.5	53.4	57.5	54.8	59.0

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

The labour market situation improved in 2014, but high unemployment is still a concern. The number of workers increased by 7.1 % compared with the previous year, and registrations with the employment agency also grew (by 4.7 %). This was in part due to efforts to reduce undeclared work. However, employment and activity rates have remained low, at 55.6 % and 67.6 % respectively, and are markedly lower for women.

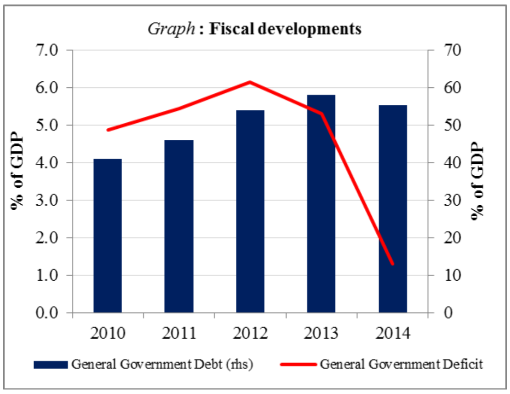
ERP recommendation 4: "Amend labour legislation to introduce further market flexibility. Reinforce sanctions to discourage undeclared work. Better target active policies for workers at risk of losing their employments and enhance labour market participation in view of an ageing population."

After having been stagnant at above 19 % for five consecutive years, the average unemployment rate fell to 18.0 % in 2014 and to 17.7 % in the second quarter of 2015. However, regional differences are huge. The average unemployment rate in the coastal region was 6.7 %, in sharp contrast with the figure of 13.4 % in the central region and 39 % in the north. Youth unemployment (15-24 years old) remained high at 35.8 %. Two-thirds of the unemployed were without a job for more than two years.

Inflation has been largely driven by global commodity prices. In 2014, lower import prices for energy and food coupled with falling wages contributed to a fall in prices. As a result, the average consumer price inflation contracted by 0.5 % in 2014, compared with a moderate increase of 1.8 % a year before. Overall, prices grew by 1.1 % on average in the first seven months of 2015, driven by food prices and despite a further decline in oil prices.

The economic crisis put a significant burden on public finances through declining revenues and further increases in mandatory expenditures. Over the last few years the country has recorded large budget deficits of around 5 % of GDP. As a major concern, total public debt has practically doubled since 2008 to reach 60.3 % of GDP in June 2015. A process of fiscal consolidation, supported by tax increases and expenditure restraint, brought the budget deficit to 1.3 % of GDP in 2014. Improvements were largely concentrated on the revenue side, expanding to 46 % of GDP, up from 43 % a year before, following increases in excise duties, vehicle registration fees, insurance taxes and real estate tax rates, as well as the introduction of incentives to facilitate repayment of tax arrears and tightening sanctions against tax debtors. On the expenditure side, freezes on pensions and public sector wages were enacted. Total spending stands at 47.3 % of GDP compared with 47.7 % a year before.

ERP recommendation 2: "Consider additional reforms for attaining long-term sustainability of the budget, such as the introduction of further restriction for early retirement and the consideration of options for individual participation into the old-age pension system on a mandatory basis, as well as the implementation of a common policy for public sector wages in the context of rationalisation and modernisation of the public sector."



The 2015 budget provides for a substantial increase in capital spending to 9.2 % of GDP, most of it intended for the construction of the highway. With this increase, the budget deficit is planned to rise to 5.3 % of GDP. The Law on Budget and Fiscal Responsibility introduced upper limits for the budget deficit of 3 % of GDP and public debt of 60 % of GDP, to be effective as of 2015. However, investment projects of national importance (such as the highway) are excluded from the deficit calculation. In the first half of 2015, the headline deficit reached 6 % of GDP, due to substantial capital spending resulting from the start of the highway construction, calling for continued fiscal discipline in particular on current spending. In September 2015, the government raised the limit for state guarantees to allow municipalities to clear arrears to the tax administration and suppliers.

Montenegro's institutional public finance framework requires additional reforms. The new fiscal policy aims to ensure the sustainability of public finances, while introducing a tax shift and incentives in favour of investment. However, its efficiency needs to be tested. The budget is also designed to boost capital spending to finance the construction of the highway. While supporting economic growth, this project will also entail significant fiscal risks. Montenegro will need to make a sustained commitment to fiscal discipline to rebuild fiscal buffers, including expenditure-side reforms and a sound public debt management strategy.

Interplay of market forces

The privatisation process is quite advanced and just a few firms remain in the privatisation programme for 2015. The final instalment for the sale of KAP's aluminium smelter was made in August 2015 (*see also chapter 8 – Competition policy*). The same investor also procured the bankrupt Nikšić bauxite mine. However, high production costs threaten the revival of the aluminium industry. There is also litigation ongoing with one of the former owners. Discrepancies in the ruling coalition over the concession of long-term leases for tourism resorts failed to secure a sufficient majority in Parliament. In June 2015, the commercial court launched a bankruptcy procedure for the Adriatic shipyard Bijela in order to facilitate the sale and restructuring of the company. In 2015, the management of the bankrupt saltworks Bajo Sekulic was temporarily given to the public enterprise National Parks of Montenegro.

Market entry and exit

The recovery of the economy is also reflected in the growing number of new companies. In 2014 there were 3,179 new companies established, 91 % of which as limited liability firms. The cost of setting up new businesses was reduced through the introduction of lower fees for public utility connections on building land, and tax exemptions for companies in strategic sectors (i.e. tourism, energy and food production). However, there is still room for further improvement for starting a business, in particular by streamlining administrative procedures. Scarce and expensive bank loans, in particular for small and medium enterprises (SMEs), also hinder enterprise creation and operation. To support investments, Montenegro should further simplify the regulatory environment, facilitate the issuing of construction permits and improve its land registration system, in accordance with ERP recommendation 7.

Legal system

Licensing, contract enforcement, access to credit and cumbersome tax administration procedures are the main obstacles for the business community. Progress has been made on reducing the number of documents needed for customs procedures through the establishment of a centralised electronic registry and by exempting companies from providing printed documents. In the context of e-Government, 300 government sites have so far been connected to a single communications network and begun to provide services to corporate users. However, full interoperability has not been achieved. Electronic registration of companies, and its extension to all regional tax administration offices, remains to be completed. The

> **ERP recommendation 7:** "Further improve the business environment by ensuring the timely implementation of the so-called "regulatory guillotine" (simplification) project, enhancing the functioning of one-stop shops at municipal level for the issuing of construction permits and the quality of the land registry."

number of enforcement cases in the courts has been significantly reduced since the introduction of a bailiff system in April 2014. Amendments to the Law on Enforcement and Securing of Claims replaced three-judge panels with decisions by individual judge, speeding up court enforcement proceedings and foreclosure of collateral. The number and the value of commercial disputes successfully resolved tripled in 2014, reaching a total of 869 cases.

Financial sector development

The recovery of the banking system remained unfinished given the need for further balance sheet adjustments. The Greek crisis did not have any significant effect on Montenegro's financial sector as none of the 14 banks operate with majority Greek capital. Banks' deposits have recovered to pre-crisis levels, but the recovery of credit is slower and more uneven. In June 2015, the stock of loans remained 15 % below its 2009 level. Although financial results remained positive and capital was reinforced, banks confront problems with debt resolution and low profitability related to high overhead costs and scale inefficiencies that add to high risk premiums. As a result, the decline in the interest rate on loans has been marginal, averaging 8.93 % in July 2015 compared to 9.55 % a year before. In July 2015, the Central Bank of Montenegro (CBCG) approved a decision on maximum interest rates on new loans in order to facilitate their reimbursement and thus reduce credit risk. However, given the weak profitability of banks, this measure could instead result in further restriction of lending.

In July 2015, the non-performing loans (NPL) ratio remained high at 16.4 % of total loans. Credit risk remained concentrated, with three banks totalling 63 % of the NPL stock. This challenge is addressed in the Law on Voluntary Financial Restructuring of Debts to Financial Institutions, known as the 'Podgorica Approach'. Adopted in April 2015, it provides a framework for voluntary out-of-court proceedings for restructuring the debts of economically viable companies. In August 2015, the parliament adopted the law for conversion of Swiss franc loans into euro. The measure concerns indexed loans totalling some € 30 million of one bank, which has challenged the measure at the constitutional court. To improve their balance sheets, some subsidiaries sold part of their troubled loans to parent banks but also to factoring companies set up by the latter, bringing up the need for a regulatory framework for effective supervision of these companies too, as also underlined by ERP recommendation 3.

ERP recommendation 3: "Implement the planned voluntary financial restructuring programme (the so-called "Podgorica approach") to address the high burden of non-performing loans on bank balance sheets from a flow perspective. In order to address the NPL stock issue, improve deadlines and efficiency of contract enforcement. Introduce effective supervision of factoring companies to improve the transparency of the financial system."

The size of the non-banking sector remained modest. In 2014, the turnover of Montenegro's Stock Exchange reached 3.2 % of GDP, the highest level in the last five years, thanks to trading –for the first time– in corporate bonds, and in government coupon bonds on the secondary market. Yet, the number of financial instruments remained limited. In 2014, the value of insurance and leasing contracts totalled 2.0 % and 3.4 % of GDP respectively.

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

Montenegro is moderately prepared in its capacity to cope with competitive pressure and market forces within the Union. Some progress was made, particularly on launching several infrastructure and tourism investment projects and some further improvement of the business environment.

Montenegro's economy suffers from low competitiveness, especially as regards industrial and agricultural products. Montenegro should improve its export capacities by gradually bringing market standards for its products and industries in line with EU standards. Competitiveness will also improve as a result of investments in energy, transport and tourism. Major reforms still need to be implemented to strengthen the country's physical infrastructure and human capital, to further improve the business environment, and to ensure a predictable and supportive regulatory environment.

In line with the ERP recommendations and in order to support long-term growth, Montenegro should pay particular attention to:

→ actively continuing education reform in order to increase the quality of education, by teaching basic and transversal skills and focusing on learning outcomes;

→ aligning with EU food safety, sanitary and phytosanitary standards in order to receive accreditation for exporting agricultural and food products to the EU;

→ strengthening its transport development strategy.

Human and physical capital

The persisting challenge of skills mismatches requires more effective active labour market policy measures and a higher quality education system that is responsive to labour market needs. Funds for active labour market programmes have remained limited and mainly focused on young graduates and seasonal workers. There is low labour mobility between regions, including during the peak tourist season. Efforts to promote lifelong learning and ensure a higher quality of education at all levels are ongoing, but have yet to yield clear results. (*See chapters 19 – Social Policy and Employment, and 26 – Education and Culture*).

ERP recommendation 5: "Actively continue education reform with a view to better aligning education and skills with labour market needs, and strengthening cooperation between education and business."

Montenegro made further progress on some major infrastructure projects. In 2014, the value of investments in fixed assets rose by 5 % to some 15 % of GDP, of which 56 % in construction and 37 % in equipment. In 2015, works started on the highway and the building of three large seaside tourism resorts continued. The power system network is gradually improving and several investments are in progress, including the interconnection cable with Italy, two wind-farms, and several small hydropower plants. However, the decision for construction of a second block in the thermal plant Pljevlja was delayed, and the construction of large hydropower plants stalled. While infrastructure investment increased in recent years, Montenegro is advised to bring its transport development strategy in line with the regional agenda on connectivity, as per ERP recommendation 6. As regards the requirement to establish a planning and funding mechanism, Montenegro set up a National Investment Committee for the development of a single sector pipeline for priority infrastructure projects.

ERP recommendation 6: "Strengthen the transport development strategy ensuring alignment with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network), and establish a credible planning and funding mechanism in the form of a single sector pipeline."

Montenegro's innovation and research capacity remained limited. Funds for research and development (R&D) programmes have increased by more than 30 % in 2014, although gross expenditure on R&D remained very modest (around 0.38 % of GDP). In July 2015 construction work started on the science and technology park in Nikšić with the aim of connecting science and business sectors. The centre will comprise laboratories of biochemistry and industrial design.

Sectoral and enterprise structure

The structure of the economy has changed little over the past five years. Services remain the main engine of the Montenegrin economy, producing more than 70 % of gross value added, while industry accounts for 11 % (with 6 % coming from utilities), agriculture 8 % and construction 4 %. The manufacturing sector is being transformed after several years of being dominated by metals production. Other industries -like pharmaceuticals- are gaining in importance, but the production of competitive high value-added products is very limited.

Industry and construction performance recovered in 2015, while the more resilient tourist industry expanded further. After registering negative output in five out of the seven years since the outbreak of the economic crisis, industrial production expanded by 12.9 % y-o-y in the first seven months of 2015. However, production was dominated by low value-added industrial products. In the first half of 2015, the value of construction works increased by 9.7 % y-o-y, compared to 2.0 % growth in the whole 2014. In the first seven months of 2015, tourism surged 21.3 % y-o-y, fuelling a number of sectors of the economy like transport, accommodation, telecommunications, retail trade and restaurants.

The vast majority of companies (around 23,000) are small, with some 200 classified as medium-sized and 100 as large. Access to finance remains a particular challenge for SMEs. Public sector support for SMEs has been limited and mainly relies on Investment and Development Fund (IDF) loan support, which in 2014 totalled €71 million and additional € 31 million in the first half of 2015. The Employment Agency also provided loans totalling € 260,000 in 2014 and € 15,000 in the first half of 2015, to finance new job creation. It is important that Montenegro follows up on the ERP reform measures intended to strengthen SMEs. Further controls on excise goods (in particular tobacco) and labour inspections are necessary to reduce the large informal economy.

State influence on competitiveness

Subsidies have been significantly reduced following the liquidation of the former aluminium conglomerate. The government provided some EUR 460 million in state aid to companies in the 2007-2014 period. The support was more pronounced in the years following the recessions, when substantial state guarantees were activated. The government maintained a favourable investment policy including a flat tax regime with low tax rates, and the possibility to transfer profits, dividends and interest earnings without restrictions. In 2015, in an effort to further encourage the key sectors of the Montenegrin economy, tax exemptions were introduced for the building of new facilities in tourism, energy and food. However, Montenegro should avoid specific measures aimed at only some businesses as these could potentially distort the market and create problems over state aid (see *chapter 8 – Competition, chapter 16 - Taxation).* The 2015 general government budget provided for a modest allocation of state aid (0.6 % of GDP for subsidies plus 0.3 % of GDP for state guarantees).

Economic integration with the EU

The Central European Free Trade Agreement (CEFTA) countries and the EU remain Montenegro’s main trading partners. In 2014, merchandise exports to the EU represented 36 % of Montenegro’s total sales abroad compared with 46 % to CEFTA. Yet, the EU was the major source of goods imports, accounting for 46 % of total imports as compared with 38 % from CEFTA. In services and foreign investment, Russia remained Montenegro’s single most important partner, accounting for 30 % of tourism stays and 25 % of FDI inflows (mostly real estate). However, investments from Russia declined in 2014 by 10 % compared with the previous year. In 2014, the EU accounted for 20 % of tourism and 39 % of foreign investment, the latter rising by 6 % y-o-y.

Trade openness in Montenegro is high (101.2 %), reflecting the strong dependency on goods imports and services exports. However, exported goods consist predominantly of low added value products, and only a few companies trade internationally. To address this issue, the government launched a direct support scheme for SMEs' harmonisation with international standards of business. In line with ERP recommendation 8, Montenegro needs to make more progress on its alignment with EU product and quality standards so that it can access relevant EU markets.

> **ERP recommendation 8:** "Make further progress with a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU. Efforts in this direction should commence with those products where preparations are advanced and where Montenegro sees the biggest export potential."

3.3. CONCLUSIONS

As regards the economic criteria, Montenegro is moderately prepared in developing a functioning market economy. Some progress was made in pursuing fiscal consolidation and improving the business environment. The economy recovered in 2013 from the double-dip recession of 2009 and 2012. After a mild slowdown in 2014, economic growth is gaining momentum again, boosted by investments. While the construction of the Bar-Boljare highway, together with other investments in energy, transport and tourism, will support economic growth, the cost of the highway risks challenging fiscal sustainability. Montenegro should make efforts to reduce its public debt. Banks are confronted with a persistently high level of NPLs, problems of debt recovery and low profitability due to the small size of the market, resulting in scarce and expensive credit. In spite of a small improvement, labour market performance remains unsatisfactory with a persistently high unemployment rate, currently 18%.

Montenegro is moderately prepared in its capacity to cope with competitive pressure and market forces within the Union. However, for industrial and agricultural products, Montenegro still suffers from low competitiveness, which should be improved. Major reforms are still needed to strengthen the country’s physical infrastructure and human capital, and to ensure a predictable and supportive regulatory environment.

4. SERBIA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process; in 2015 the enlargement countries were invited to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia is moderately prepared in developing a functioning market economy. Good progress was made to address some of the policy weaknesses, in particular with regard to the budget deficit, labour market and the business environment. However, fiscal imbalances are still high and major sectors of the economy are in need of reform. Credit activity is weak, also constrained by very high level of non-performing loans. The private sector is underdeveloped and hampered by weaknesses with the rule of law. In line with the ERP recommendations and in order to support long-term growth, in the coming year Serbia should pay particular attention to:

→ sustaining efforts to reduce the budget deficit and the high public debt level;

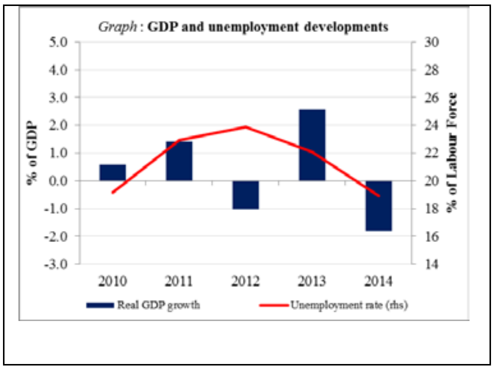
→ advancing private sector development through the restructuring and privatisation of state-owned enterprises (SOEs) and addressing the challenges of stagnating credit growth and non-performing loans (NPLs);

→ implementing public administration reform.

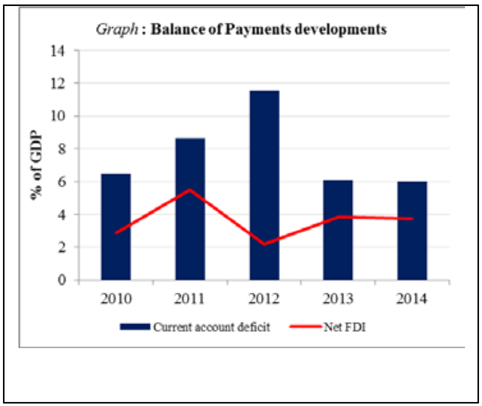
Economic policy essentials

The government's determination to pursue economic reforms has strengthened. Serbia submitted its Economic Reform Programme, covering the period 2015-2017, in March 2015. The objectives of the programme are to achieve macroeconomic stability, to remove obstacles to growth and to improve competitiveness. To this end, the authorities have already undertaken significant measures to reduce the budget deficit. They have also outlined an ambitious reform agenda aimed at restructuring state-owned enterprises, streamlining and improving the performance of public administration, improving the business environment, and strengthening financial stability. Serbia needs to follow up on its commitments and take further steps to implement the ERP recommendations, which are set out below. Since February, the government reform agenda has been supported by a new arrangement with the International Monetary Fund.

Macroeconomic stability



Serbia's economy is recovering from a third recession in five years, but GDP remains around its pre-crisis level. Economic growth averaged 1.0 % over 2008-2013, while it was negative in 2014. The economy has become less dependent on consumer spending and more open as exports have increased by close to 50 % since 2009. The shift to new sources of growth is incomplete as investments remain weak despite some signs of picking up in 2015. Slow economic development has led to stagnating average income per capita (PPS), which stands at 36% of the EU average.



External imbalances have been reduced by growing exports and subdued imports. The current account deficit fell below 5.0 % of GDP in the first half of 2015, down from double-digit levels in the beginning of the decade. Most of the deficit was covered by net foreign direct investment, which stabilised at close to 4 % of GDP, still below the needs of the economy. External debt has increased since mid-2014 to around 80 % of GDP but, in view of shrinking external imbalances, debt sustainability does not raise immediate concerns. The official foreign exchange reserves stand at a comfortable level, covering about seven months of imports of goods and services — an important buffer in view of external risks.

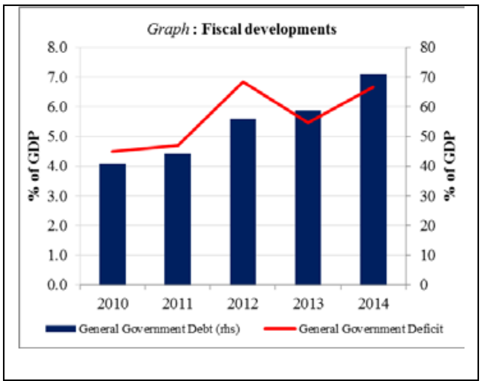
Table 4.1:
Serbia - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	0.6	1.4	-1.0	2.6	-1.8	-0.5
Private consumption	Ann. % ch	-0.6	0.9	-2.1	-0.4	-1.3	-1.0
Gross fixed capital formation	Ann. % ch	-6.5	4.6	13.2	-12.0	-2.7	6.5
Unemployment (>15 years old)	rate %	19.2	23.0	23.9	22.1	18.9	18.6
Employment (registered)	Ann. % ch	-3.6	-3.1	-1.1	-1.0	-0.8	6.6
Wages (average, net real)	Ann. % ch	7.4	11.1	9.0	5.7	1.1	-0.7
Current account balance**	% of GDP	-6.8	-10.9	-11.6	-6.1	-6.0	-5.8
Direct investment (FDI, net)**	% of GDP	-2.9	-5.5	2.2	3.9	3.8	4.0
CPI (end of period)	Ann. % ch	10.2	7.0	12.2	2.2	1.7	1.9
Exchange rate RSD/EUR	Value	102.90	101.96	113.01	113.09	117.25	121.00
General government balance	% of GDP	-4.5	-4.7	-6.8	-5.5	-6.7	-1.9
General government debt	% of GDP	40.8	44.2	55.9	58.8	71.0	73.2

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

Unemployment remains very high despite signs of improving labour market conditions. Unemployment fell below 20 % and both employment and activity rates have increased. Although some of the new jobs were in the public sector or in informal employment, large gains were observed in registered private employment, especially for women. Most of these jobs, however, went into less paid, low productivity sectors. Average real wages fell as a result of public sector wage cuts. However, private sector wages have recently increased.

Prices have been broadly stable, allowing the central bank to reduce interest rates. Inflation has been below the central bank tolerance band (4 % ±1.5 percentage points) for more than a year. Low inflation is the result of low international prices of primary commodities, weak domestic demand, exchange rate stability and delays in administrative price adjustments. The low inflationary environment and a rapidly falling budget deficit in 2015 allowed the central bank to cut its key interest rate in successive steps, from 8.0 % in February to 5.0 % in September 2015 and to gradually cut the foreign currency reserve requirement ratio by six percentage points by February 2016.



The budget deficit fell sharply in the first half of 2015, but fiscal consolidation still needs to be sustained and underpinned by implementing structural reforms. The 2015 budget targets a deficit of 5.8 % of GDP and is based on a large decrease in current expenditure. Considerable savings have already been made from the cuts in pensions and public sector salaries implemented last year. Additional savings are expected from a number of other measures ranging from public administration reform, to lower subsidies and reforming public enterprises.

Revenue collection continued to improve in 2015, in particular due to some excise duties and non-tax revenue (e.g. telecom licences and SOEs dividends). In addition, expenditure restraint and under execution of capital spending have led to a better-than-expected budgetary performance. By the end of August the cumulative deficit stood at only 1.1 % of the annual GDP — a third of its level in the previous year and far below the target.

ERP recommendation 1: 'Strengthen fiscal consolidation by using any excess revenue and current expenditure savings to further reduce budget deficits in 2015 and the following years. Underpin the medium-term consolidation path by implementing the planned structural reforms.'

In view of Serbia's high indebtedness and the extensive structural reform agenda, and in line with ERP recommendations, consolidation efforts need to be sustained. This requires Serbia to tackle the biggest sources of fiscal risk by further strengthening tax administration and public finance management, implementing public administration reform and restructuring state-owned enterprises in line with adopted plans.

ERP recommendation 3: 'Further strengthen public finance management, notably by improving the budgetary process and the capacity of the tax administration. Compile and start submitting to Eurostat excessive deficit procedure notification tables before the end of 2015.'

The recently improved fiscal performance followed years of increasing fiscal imbalances and missed budget deficit targets. The budget deficit averaged 5.7 % of GDP over 2009-2014, regularly overshooting planned deficits. It went up to 6.7 % of GDP in 2014, reflecting mainly higher spending on interest payments, activated government guarantees and expenditure related to bail outs of failed state-owned banks and loss-making SOEs. Revenue was lower than planned and budget execution was marked by significant under execution of capital expenditure, pointing to a general problem of weak preparation of public investment projects. Government debt rose above 70 % of GDP.

Interplay of market forces

Some steps have been taken to start restructuring large state-owned enterprises. Payment discipline between SOEs has been improved and could be further strengthened following recent legislative amendments. However, SOEs restructuring continued to face delays and big utility companies remain a significant source of market distortions and fiscal risk. Therefore, it is important that Serbia advances the restructuring of these companies in accordance with ERP recommendations.

In December, the government adopted guidelines for restructuring Srbijagas, the state-owned gas company. In line with these, in early July it adopted a decision to unbundle the operation of gas transmission networks and distribution activities. The financial restructuring of the company is still awaited and the resolution of its biggest debtors needs to advance further.

> **ERP recommendation 2:** 'Advance the restructuring and privatisation of state-owned enterprises, prioritising the biggest companies. Introduce better corporate governance and advance, as planned, the organisational and financial restructuring of large, loss-making utilities. […]'

A corporate restructuring plan for Elektroprivreda Srbije, the state-owned power utility, was adopted in November and — as a first step — the company was reorganised to increase its efficiency. A financial restructuring plan, which contains measures to reduce costs and improve revenues, including a 4.5 % increase in the regulated electricity tariff, was adopted in June. In January 2015, the government announced full liberalisation of the electricity and gas market, allowing users to switch to a distributor other than the state-owned utility company. However, only 5 % of all users have done so, as households and small buyers still have the right to guaranteed usage at regulated prices.

In July, Railways Serbia was unbundled into passenger, freight and infrastructure, including by creating a holding company. Corporate and financial restructuring plans have been prepared and are planned to be adopted by the government in September.

Privatisation attempts have been revived recently, although results so far are marginal. The sustainable operation and future privatisation of the steel mill in Smederevo is a key challenge. In June, the government took steps to start the privatisation of the majority state-owned Telekom Srbija. In January, it adopted an action plan to resolve 188 companies through a bankruptcy procedure. In addition, about 200 enterprises are expected to be fully or partially privatised, either by equity or asset sales, or through strategic partnership.

The protection of companies in restructuring from forcible collection of debts and bankruptcy expired in June. However, it was extended for 37 of them until October, while for another 17 firms, deemed of strategic importance and employing some 22.000 people, protection was extended until end of May 2016. As the end of the restructuring process is expected to result in redundancies, the government has put in place an adequately funded social programme. In view of the time and capacity needed to process such a large number of privatisations, the government should prioritise the restructuring of the biggest and most problematic cases.

Market entry and exit

Procedures for construction permits have been improved but further efforts are needed to ensure proper implementation. As in previous years, in 2014 the number of newly established companies (8 209) was more than three times the number of companies closed (2 601). Still, market entry has continued to be burdened by lengthy and costly procedures to obtain various permits. One major improvement was the introduction of a new integrated procedure for issuing construction permits ('one-stop shops'); its implementation has in most cases significantly shortened the time required to obtain permits. The establishment of an electronic permitting system is envisaged to be set up by 2016. The issue of converting usage rights into ownership rights of construction land, which had hindered potential investments, was solved but further efforts are needed to ensure proper implementation.

Legal system

Legal predictability and enforcement have remained weak and significant efforts are needed to further improve the business environment. Many laws, important for structural reforms and socioeconomic development, are still adopted through emergency procedures, without proper consultation and public debate. Moreover, the implementation of laws remains problematic as there are long delays in the adoption of by-laws. The judicial system has been slow to enforce property rights.

ERP recommendation 5: 'Improve the business environment and tackle the grey economy, notably by better regulating para-fiscal charges, business inspections, and leasing of labour. Take steps to further simplify the regulatory environment by re-launching the 'regulatory guillotine'.'

The backlog in the courts is still substantial and companies often avoid using the courts as a solution to their problems. Enforcement of legislation on property restitution, which is expected to improve legal clarity over real estate ownership, is making progress; 42 % of all claims submitted have now been resolved.

The informal economy remains a major obstacle to fair competition and business development. To tackle the grey economy, the government adopted an action plan and set up a coordination body. A new law on inspection oversight, introducing a risk assessment system and better coordination between different administrative bodies, was adopted in April. Implementation of the new legislation and rules still needs to be tested. Further efforts are needed to better control para-fiscal charges and to regulate labour leasing, and to further simplify the regulatory environment in accordance with ERP recommendations.

Financial sector development

ERP recommendation 4: 'Advance with the rebalancing of macroeconomic policies with fiscal consolidation as a pre-condition for a more accommodative monetary policy stance, with a view to fostering a pick-up in the pace of credit extension. In this context, increased efforts to address the high burden of non-performing loans on banks' balance sheets, involving all key stakeholders including the central bank as necessary, also appear warranted.'

The banking system is still facing a number of challenges, including weak credit activity and a high level of non-performing loans (NPLs). The financial sector continued to be dominated by commercial banks, mostly foreign-owned, holding more than 90 % of all assets, followed by insurance companies with 5.2 %. In June, the central bank enhanced its monitoring of majority Greek-owned banks and limited their transactions with parent banking groups. Euroisation continued to be widespread, with about three quarters of deposits and of loans to households and businesses denominated in or linked to foreign currencies.

Financial intermediation was revived only temporarily due to a boost from a government subsidised programme. Still, credit growth remained weak and credit to the private companies continued shrinking, marking an absolute five-year low in April. Commercial banks have channelled their resources into lending to the government, albeit at a slower pace, and in building up their net foreign assets.

Mirroring the difficult economic environment and constraining lending activity, NPLs remained very high at 22.8 % in June. However, the banking system as a whole remained adequately capitalised and liquid. With the help of international financial institutions, the government adopted a comprehensive strategy and an action plan for NPL resolution in line with ERP recommendations. In August, the central bank also adopted an action plan for implementing this strategy. Special bank diagnostic studies, to be completed in October, should also provide additional information on the quality of bank assets and support the implementation of the NPL strategy. Governance weaknesses prompted the strengthening of the supervisory and improvement of the bank recovery and resolution frameworks.

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

Serbia is moderately prepared in terms of capacity to cope with competitive pressure and market forces within the Union. **Some progress** was made particularly with regard to further opening up the labour market and providing support for the development of small and medium-sized enterprises (SMEs). However, the education system has remained inefficient, physical infrastructure underdeveloped and the informal sector and state aid have remained substantial.

In line with the ERP recommendations and in order to support long term growth, in the coming year Serbia should pay particular attention to:

→ improving the quality of the education system and gearing it towards labour market needs;

→ stimulating private investments and speeding up the implementation of public infrastructure projects;

→ providing a transparent framework of state support to the private sector, with a focus on SMEs.

Human and physical capital

ERP recommendation 6: ‘Adopt a comprehensive and well-targeted set of active labour market policies, with a focus on youth and the long term unemployed, as well as dedicated skills upgrade programmes. The finalisation of the national qualifications framework should be the first step in a progressive reform of the education system, aimed at improving the outcomes of the system, thereby enhancing the human capital productivity.’

The needs of the economy and a worsening demographic situation demand further reforms of human capital policies in accordance with ERP recommendations. Although Serbia’s public spending on education is comparable to that of EU countries, its quality has remained low, manifested in below-average OECD Programme for International Student Assessment (PISA) test scores and a high number of unskilled workers. Despite recent improvements, the labour market is still characterised by high unemployment, skills mismatches, a high share of informal employment, and high migration rates (especially of highly-skilled workers).

The efficiency of the education system needs to be improved by rationalising the school network and gearing vocational education more to labour market needs. Additional emphasis should be placed on teacher training and curriculum reforms at basic levels of education. This is the means by which the basic and transversal skills and student competences can be improved, better preparing them for the job market or further education. Serbia has maintained a relatively high proportion of public investment in research and innovation. However, there is little private investment and little cooperation between public and private researchers.

Active labour market policies have been in decline until recently. They need to focus on youth and the long-term unemployed and provide stimulation to employers to reduce the informal forms of employment, in line with ERP recommendations.

Physical infrastructure is severely affected by years of underinvestment and concerted efforts are needed to boost private and public investment. Investment has still not recovered to pre-crisis levels and remained at about a quarter below its peak. Public investment, in particular, has been subdued. The poor state of infrastructure undermines competitiveness and deters foreign investors, hampering regional and EU trade integration. There is a clear need to increase public investment, improve preparation and speed up the implementation of public projects, in particular those included in Serbia-EU's 'single project pipeline.'

> **ERP recommendation 7:** 'Stimulate private investment, for example by establishing public schemes to support lending to SMEs and research activities in companies. To increase public investment, improve preparation and speed up the implementation of public projects. Step up the works on corridors VII and X in line with the regional core network. Improve energy production and transmission, most notably by better governance of energy firms, regulation of the network and the construction of gas inter-connectors.'

The ongoing fiscal consolidation and the reform of governance of public projects should create the conditions for increasing infrastructure investment and stepping up work on regional transport corridors in accordance with ERP recommendations. In addition, to diversify energy supplies Serbia should go ahead with the construction of gas inter-connectors as planned. Private investment should be further stimulated by establishing public schemes to support lending to SMEs and research activities in companies, in line with ERP recommendations.

Sectoral and enterprise structure

The structure of the economy remained broadly unchanged and reducing the large informal sector remains a major challenge. With a share of 50.9 % of GDP, services continued to play a major role in the economy. In 2014, agriculture slightly increased its share to 8.1 % of GDP, whereas industry's share fell by 1.7 percentage points to 20.7 % of GDP due to the floods which severely affected the energy and mining sectors. Employment was roughly unchanged across sectors, with agriculture remaining the biggest sector, employing almost a fifth of the labour force. The large informal sector represents a major obstacle for economic development, fuelled by weak rule of law, and imposes significant risks and costs to the overall economy.

SMEs account for over 70 % of employment, but contribute only 53 % of the total gross value added. They remain disadvantaged compared to large companies and state-owned companies that receive state aid. SMEs are the most affected by the poor access to finance in Serbia, Limited progress has been made as regards the development of SME-oriented financial instruments.

State influence on competitiveness

State support for loss-making SOEs remained significant and needs to be addressed in line with ERP recommendations. In 2014, spending on these measures combined has reached the highest level since 2000. The increase over the last three years was in large part due to the delayed process of resolution of SOEs. However, signalling a change in policy, the 2015 budget law does not envisage new issuance of state guarantees for liquidity support and limits new project-based guarantees. More predictable instruments of state support to the private sector need to be developed to benefit both foreign and domestic investors. State support should also be redirected towards efficient and horizontal objectives, such as support to SMEs and research and development.

> **ERP recommendation 2:** '[…] Review the efficiency of all forms of state aid and take steps to reduce it. Proceed to revisit public sector employment in a sustainable manner by implementing the Action plan on public administration reform.'

Economic integration with the EU

Serbia improved its external competitiveness and increased further its trade integration with the EU. A weaker dinar and a relative decrease of labour costs have boosted external competitiveness. The EU increased its trade with Serbia and remained by far the country's main trading partner, accounting for 69 % of total exports and 61 % of total imports of goods. Exports to Central European Free Trade Agreement (CEFTA) countries represent 20 % of all exports and have the potential to be boosted by the planned trade liberalisation in the services sector.

The EU also remains the main source of FDI with a share of almost three-quarters. Through the network of various free trade agreements, Serbia enjoys good market access but needs to facilitate trade by measures removing non-tariff barriers, especially for companies operating in global value chains.

4.3. CONCLUSIONS

As regards the economic criteria, Serbia is moderately prepared in developing a functioning market economy. Good progress has been made to address some of the policy weaknesses and the positive momentum for advancing structural reforms needs to be preserved. Serbia's economy is recovering from a recession. Thanks to significant consolidation measures and better tax collection, the budget deficit has fallen sharply. Fiscal consolidation should be sustained and underpinned by implementing reforms as planned. Inflation remains very low, allowing the central bank to reduce interest rates. Unemployment, though very high, has fallen below 20%. Progress has been made with restructuring of publicly owned companies and main utilities, but it needs to advance further. The private sector is underdeveloped and hampered by weaknesses in the rule of law and difficult access to finance. The process of economic reforms needs to continue with particular emphasis on restructuring state owned enterprises and public utilities.

Serbia is moderately prepared in terms of capacity to cope with competitive pressure and market forces within the Union. The education system has remained inefficient, physical infrastructure underdeveloped and the informal sector and state aid are substantial. Serbia needs to improve the quality of the education system, gearing it towards labour market needs, stimulate private investments and speed up the implementation of public infrastructure projects. It needs to better regulate para-fiscal charges and provide a transparent framework of state support to the private sector, redirecting it towards efficient and horizontal objectives, such as support to SMEs and research and development.

5. TURKEY

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process. In order to improve their economic governance, in 2015 the enlargement countries were asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is well advanced and can be considered a functioning market economy. Economic growth was moderate in 2014. There was, however, **no progress** in reducing the underlying macroeconomic imbalances. The large external deficit continued to make the Turkish economy vulnerable to financial uncertainty and changes in global risk sentiment. Inflation was running at a relatively high rate and exceeded the official target again; nevertheless the central bank cut interest rates.

Monetary and fiscal policy should be adjusted to lower macroeconomic imbalances. At the same time, structural reforms should be accelerated to improve the functioning of the markets for goods, services and labour. In line with the ERP recommendations and in order to support long-term growth, in the coming year Turkey should pay particular attention to:

→ promoting domestic saving, including through a sufficiently restrictive fiscal policy, in view of the persistently large current account deficit;

→ making monetary policy more focused on the pursuit of price stability;

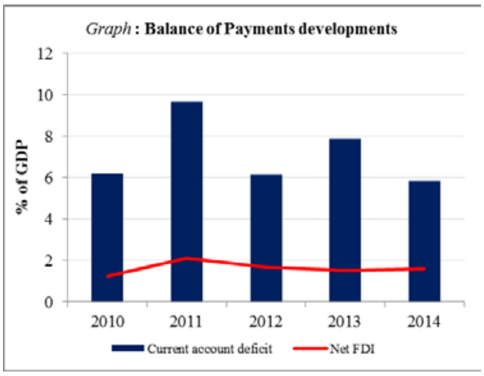
→ improving the business environment by strengthening the rule of law, making it easier to start a business and strengthening competition.

Economic policy essentials

Turkey's resolve to address its underlying macroeconomic imbalances has been uneven. The government's Economic Reform Programme for 2015-17, submitted to the Commission in March 2015, projects an optimistic macroeconomic scenario in which GDP growth strengthens while unemployment, inflation and the current account deficit decrease. Under the programme, structural reforms will be implemented as part of Turkey's 10th Development Plan, covering the period 2014-2018. However, the fragmentation of responsibilities between government bodies continued to complicate the coordination of budgeting and medium-term economic policy-making. Uncertainty increased over the central bank's independence in carrying out monetary policy to the detriment of macroeconomic stability.

Macroeconomic stability

The Turkish economy has grown at an average annual rate of 3 % over the past three years. In 2014, GDP growth started strongly, but slowed down after the introduction of targeted policy measures to rein in consumer borrowing and a hike in interest rates. Annual GDP growth of 2.9 % was mainly driven by net exports, which benefited from a temporarily more competitive exchange rate and a sharp fall in gold imports. Domestic demand was relatively subdued, particularly investment. In the first half of 2015, GDP growth remained relatively constant (3.1 % year-on-year), but now with consumer spending as the main driver in the wake of the lower oil price while exports declined. GDP per capita was 53% of the EU average in 2014, based on purchasing power parity.



Turkey's long-standing current account deficit has remained very high. The deficit has averaged 6.6 % of GDP over the past three years, the largest of all G20 countries. It narrowed somewhat in 2014 in the context of lower domestic demand growth, a temporary surge in exports and a sharp fall in imports of non-monetary gold. With Turkey being a large energy importer, the lower dollar price for crude oil has also been favourable.

Turkey's current account deficit reflects a persistent shortfall of domestic savings, which needs to be offset with capital inflows. Most capital inflows are portfolio investments by foreign investors and foreign borrowing by Turkish banks. In recent years, only a small proportion of the required capital inflow has been in the form of relatively stable foreign direct investment. The dependence on volatile types of capital inflows has made the Turkish currency and economy vulnerable to a sudden loss of investor confidence. This was most recently seen before the general elections on 7 June and 1 November 2015 when uncertainties about the future direction of Turkey's economic policies put the lira under strong downward pressure and again during the unrest in global financial markets starting in July 2015.

Gross external debt as a percentage of GDP has edged higher, reaching 57.5 % of GDP at the end of March 2015. A particular concern relates to the foreign currency debt of private companies that receive most of their revenues in domestic currency: when the lira depreciates, their debt-servicing capability deteriorates.

The number of jobs increased at a rate commensurate with output growth, but markedly below the growth rate of the labour force. In 2014, the unemployment rate increased by 1.1 percentage points to an annual average of 9.9 % as the labour force continued to grow faster than available jobs. Labour force growth is mainly driven by a growing number of people of working age, but also by some rise in the economic activity rate.

Table 5.1:
Turkey - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	9.2	8.8	2.1	4.2	2.9	3.2
Private consumption	Ann. % ch	6.7	7.7	-0.5	5.1	1.3	5.1
Gross fixed capital formation	Ann. % ch	30.5	18.0	-2.7	4.4	-1.3	5.1
Unemployment rate	%	10.9	9.0	8.3	8.9	10.1	10.5
Employment	Ann. % ch	6.3	6.6	3.1	2.8	1.6	2.1
Wages	Ann. % ch	11.8	9.7	11.5	12.4	14.2	14.5
Current account balance**	% of GDP	-6.2	-9.7	-6.1	-7.8	-5.8	-5.8
Direct investment (FDI, net)**	% of GDP	1.2	2.1	1.7	1.5	1.6	1.6
CPI, average	Ann. % ch	8.6	6.5	8.9	7.5	8.9	7.6
Exchange rate TRY/EUR	Value	1.99	2.33	2.31	2.53	2.91	2.86
General government balance	% of GDP	-2.9	-0.8	-0.3	-1.6	-1.5	0.1
General government debt	% of GDP	42.3	39.1	36.2	36.3	33.5	:

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

The employment rate of women has remained at a very low level. The overall employment rate fell to 53.2 % in 2014, with a large difference between men (75.0 %) and women (31.6 %). Despite the low proportion of women actively looking for work, their unemployment rate remains significantly higher than the unemployment rate for men. In addition, about one third of women who are considered to be employed are in fact unpaid family workers in the agricultural sector. One quarter of young people were not in employment, education or training.

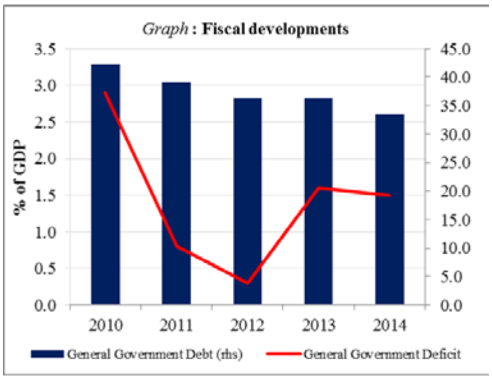
The efficient functioning of the labour market continued to be impeded by a lack of flexibility, for example on labour contracts, while undeclared work remained widespread. This calls for a deepening and widening of labour market reforms, which also need to be more inclusive.

Despite declining oil prices, inflation remained in high single digits. This has significant costs in terms of macroeconomic stability, resource allocation and redistributive effects. Fuelled by a depreciating currency and accelerating food prices, consumer price inflation increased from 7.4 % year-on-year at the end of 2013 to 8.2 % in December 2014, i.e. clearly above the official target of 5 %. In 2015, headline inflation has fallen only slightly despite a much lower oil price year-on-year. The Turkish lira depreciated by 12.9 % against the euro and by 8.2 % in real effective terms over the twelve months to August 2015.

ERP recommendation 2: ‘Continue to take consistent steps to reinforce the focus of monetary policy on the pursuit of price stability, with other policy objectives being pursued with separate measures, and thereby contribute to improving both the functioning and the credibility of the inflation targeting regime.’

The central bank continued to pursue multiple objectives as part of an overly complex monetary policy framework that hampered transparency and predictability. Although price stability is the primary objective, the central bank is also pursuing macro-financial stability and trying to dampen exchange rate fluctuations. The central bank lowered its key interest rate from 10 % to 8.25 % between May and July 2014 and to 7.5 % in January-February 2015, i.e. to below the inflation rate. These interest rate cuts were inconsistent with the inflation target and took place against the background of repeated strong calls for lower interest rates from the President and parts of the government. Furthermore, negative real interest rates are contrary to the need to raise the low private saving rate.

Turkey has reversed the limited simplification it made to its complex monetary policy framework in January 2014. Monetary policy should be focused more on its primary objective of price stability to attain the official inflation target (ERP recommendation 2).



On public finances, the budget deficit remained moderate and public debt continued on a sustainable path. The 2014 central government budget deficit is estimated at 1.3 % of GDP, which is marginally higher than in the preceding year (1.2 %) but lower than the revised target of 1.4 %. Revenues increased by 9.3 % year-on-year while expenditures rose by 9.8 %, which is below nominal GDP growth for the first time in many years. General government debt increased by 3.5 % in absolute terms in 2014, but declined by 0.6 percentage points as a percentage of GDP to 33.5 %, i.e. it is clearly at a sustainable level.

There was no progress on increasing the transparency of the fiscal framework, which continued to suffer from the lack of timely information in accordance with international standards. Adopting a fiscal rule would increase credibility and support the envisaged reduction of the structural fiscal deficit (ERP recommendation 1).

ERP recommendation 1: 'Promote domestic saving in view of the persistently large current account deficit. Fiscal policy has an important role to play in this regard by following a sufficiently restrictive stance. Reducing the rigidity of public expenditures would help to make the fiscal policy stance more responsive to macroeconomic needs. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.'

Interplay of market forces

Privatisation slowed down and there was no further progress on price liberalisation as the government continued to intervene in the price-setting mechanism in key sectors. Following a surge in 2013, privatisation activity has decelerated recently, with the total volume of completed deals decreasing from EUR 9.4 billion (1.5 % of GDP) in 2013 to EUR 4.8 billion (0.8 % of GDP) in 2014. The share of the energy sector in privatisation tenders remained high. Competition could be increased by continued liberalisation of product and services markets.

The proportion of directly administered prices in the consumer price index (CPI) basket has remained below 5 %. However, food and alcohol prices, which together make up more than 25 % of the consumer basket, are highly sensitive to policy decisions. For energy (natural gas and electricity), automatic pricing mechanisms were applied in principle. In practice, however, the government continued to set end-user prices, effectively suspending the automatic pricing mechanisms. There was no progress on eliminating the charging of higher prices to one group of consumers in order to subsidise lower prices for another group in the wholesale and retail electricity markets.

Market entry and exit

Starting a business became more cumbersome and expensive. Market exit also remained costly and long and insolvency proceedings were still heavy and inefficient. The number of newly established businesses increased by 16.3 % in 2014 even though the costs and difficulties of starting a new business increased. Starting a business required seven separate procedures and took 6.5 days on average. The average cost of starting a business increased to 16.7 % of per capita income in 2014 from 12.7 % in the preceding year. Obtaining a construction permit is still very burdensome and time-consuming.

The number of businesses closing down or being liquidated fell by 3.3 % compared with 2013. Closing a business also remained expensive and time-consuming. Insolvency procedures lasted an average of 3.3 years and recovery rates — at 27.9 % on average — remained very low in 2014 although somewhat better than in the preceding year. Making it easier to start a business should be part of a more wide-ranging improvement of the business environment, as outlined in ERP recommendation 3.

ERP recommendation 3: ‘Take sustained efforts to improve the business environment and Turkey’s attractiveness as an investment destination, not least for foreign direct investments, in view of the continuing dependence on large capital inflows. This requires wide-ranging reforms, including strengthening the rule of law, making it easier to start businesses, and strengthening competition through continued liberalisation of product and service markets.’

Legal system

The legal system continued to function relatively well in the area of property rights, but in general no further progress was observed. The legal appeal by the dispossessed owners of Bank Asya should reassure investors about the strength and independence of the legal system. A reasonably well-functioning legal system has been in place for several years in the area of property rights. Enforcement of commercial contracts was still a rather lengthy process, partly because commercial court judges were insufficiently specialised. The expert witness system still operated as a parallel judicial system, without improving overall quality.

Out-of-court dispute settlement mechanisms are seldom used, except in the insurance sector, tax and customs. The judicial system and its administrative capacity could be further improved. A proposal for a new amnesty on interest payments related to tax arrears has been submitted to parliament. Recurrent amnesties and restructuring mechanisms of this kind discriminate against regular taxpayers and harm the tax and social security administrations’ collection capacity in the long term. Taxpayers and other citizens subject to fines had a clear advantage in delaying their payments, especially in the current inflationary environment.

Financial sector development

Despite declining profitability in banking, the financial sector generally performed well and continued to demonstrate resilience. Banks continued to dominate the financial sector, with their share of the sector’s total assets remaining stable at around 87 %. The value of banking sector assets as a ratio of GDP continued to increase, rising from 111 % in 2013 to 114 % in 2014. State-owned banks’ share of total banking sector assets increased slightly, while the share of foreign banks also increased slightly to 14.6 % in February 2015. The share of the relatively small insurance sector (including private pensions) remained around 5 %.

Macro-prudential measures to rein in lending growth, combined with the central bank’s January 2014 interest rate hike, led to a decline in the growth rate in bank lending. Nevertheless, total bank lending still increased by 18.5 % in 2014. The net profit of the banking sector was flat in 2014. The sector’s capital adequacy ratio remained significantly above the regulatory target of 12 %, with the figure standing at 15.1 % in July 2015. The proportion of non-performing loans in total banking sector loans remained broadly stable at just below 3 %.

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

Turkey has a good level of preparation in achieving the capacity to cope with the competitive pressure and market forces within the EU. Some progress was made, particularly on improving educational attainment and schooling rates and on further liberalising the energy sector. However, significant problems remained over the quality of education and gender equality in education. Moreover, there was no progress in improving the transparency of state aid and further constraints and exceptions were introduced in the area of public procurement. The depreciation of the lira improved overall price competitiveness.

In line with the ERP recommendations and in order to support long-term growth, in the coming year Turkey should pay particular attention to:

→ improving the functioning of the markets for goods, services and labour, which would increase potential growth and competitiveness on a sustainable basis;

→ improving qualifications of low-skilled workers through training and increasing women's labour force participation through more flexible working conditions.

Human and physical capital

Reforms and increased spending on education have so far generated a positive impact on educational attainment and schooling rates. However, significant problems remain over gender equality and the quality of education. Schooling rates continued to increase at all levels of education, reaching 99.6 % for the first four years and 94.5 % for the second four years of primary school and 76.7 % for secondary school in 2013/14. However, sizeable gaps persist in schooling rates for girls, especially in secondary school. Participation in higher education remained low by international standards, although the percentage of the population aged 30-34 with tertiary education qualifications increased from 19.5 % in 2013 to 20.5 % in 2014.

> **ERP recommendation 4:** 'In particular, Turkey should upgrade and make better use of its human capital through the pursuit of the education agenda and the deepening and widening of labour market reforms. Specifically, the qualifications of low-skilled workers should be improved through training and female labour force participation should be stimulated through flexible working conditions.'

According to the most recent of the OECD's regular assessments of educational performance for 15-year-old students (PISA), the mean score of Turkish students improved in the three categories of science, mathematics and reading between 2009 and 2012. However, the improvement was less pronounced than in the preceding three-year period and Turkey remained 48 points below the OECD average.

Turkey needs to make better use of its human capital in order to stimulate sustainable and inclusive growth and competitiveness, both through raising qualifications of the workforce and labour market reforms stimulating female employment, in line with ERP recommendation 4.

Improvements in the country's physical capital were modest. Total investment declined by 0.2 percentage points to 20.1 % of GDP in 2014, while private investment increased its share of GDP by 0.3 percentage points to 15.9 %. Public investment, however, was cut back significantly following a surge in 2013 and its share of GDP was 4.2 %. Gross foreign direct investment (FDI) inflows to Turkey increased slightly to 1.6 % of GDP and the FDI stock as a proportion of GDP increased from 19.3 % to 22.3 % in the course of 2014. R&D expenditure (both public and private) is continuing to edge higher but was still low at 0.95 % of GDP in 2013, far below the government's current target of 1.8 % of GDP by 2018.

Little progress was made in upgrading Turkey's transport infrastructure in 2013: the motorway network remained unchanged while the total length of other roads and of the railway network was only extended slightly. In telecommunications, there was a switch from fixed line subscribers to mobile phone subscribers and a rise in the internet penetration rate for households from 49 % in 2013 to 54 % in 2014. No progress was made on aligning telecommunications legislation with the EU framework. The regulator launched a call for tenders over the operating rights for 4G licences in five frequencies, but interrupted the procedure after the President intervened.

Progress continued in the liberalisation of the energy sector. Following the entry into force of a new electricity market law in March 2013, the proportion of the market open to competition was increased further in 2014 with the aim of achieving 100 % by 2016. Progress also continued in the privatisation of electricity-generating assets. Further progress is needed to open the natural gas market so that there is competition for the state-owned corporation BOTAŞ. A transparent and cost-based pricing mechanism for electricity and gas remains to be properly implemented. The Turkish Energy Stock Company (EPIAS) was established in April 2015 to carry out the financial reconciliation transactions on organised wholesale electricity markets.

Sectoral and enterprise structure

In 2014, GDP grew by 2.9 %, while employment increased only by 1.6 %, indicating an increase in labour productivity in the overall economy. The sectoral breakdown of employment growth shows only a small shift towards the services sector, which accounts for 51 % of total employment. Industry accounts for 20.5 % of employment, while construction and agriculture employ 7.4 % and 21.1 % respectively. The share of agriculture in GDP continued its long-standing downward trend.

The private sector's share of GDP declined from 86.4 % in 2013 to 84.6 % in 2014, but is still quite large by EU standards.

State influence on competitiveness

There was no progress in improving the transparency of state aid and there was some backsliding in the alignment of public procurement rules. Legislation to implement the state aid law, originally scheduled to be passed into law by September 2011, has been postponed for yet another year until the end of 2015. The State Aid Authority has still not formally set up a comprehensive state aid inventory or adopted an action plan to align all state aid schemes, including the 2012 incentives package, with the *acquis*. New amendments to the legal framework for public procurement (see Chapter 5 below) moved the legislation further away from the EU *acquis*.

Economic integration with the EU

Turkey's trade and economic integration with the EU is high and increased further in 2014. Moreover, Turkey recently gained some international price competitiveness as a result of currency depreciation. The openness of the economy, measured by the value of exports and imports of goods and services as a percentage of GDP, increased in 2014. The proportion of trade with the EU out of Turkey's total trade increased from 38.5 % to 39.3 %. The EU proportion of Turkey's exports increased from 41.5 % to 43.5 %, while its proportion of Turkish imports remained stable at 36.7 %.

The EU remained the largest source of FDI flows into Turkey and its share of the total increased from 51.7 % to 55.9 %. Close to three quarters of the FDI stock in Turkey originates in the EU. The depreciation of the Turkish lira between June 2014 and June 2015 has improved Turkey's international price competitiveness.

5.3. CONCLUSIONS

Regarding the economic criteria, the Turkish economy is well advanced and can be considered a functioning market economy. Economic growth has been moderate. Turkey continued to face external and internal imbalances, calling for adjustments in monetary and fiscal policies as well as an acceleration of comprehensive structural reforms. The large current account deficit continued to contribute to the economy's vulnerability to shifts in global monetary conditions and risk sentiment. On the internal side, inflation continued to run at a relatively high rate, which is problematic in terms of macro-economic stability, resource allocation and re-distributive effects. It again exceeded the official target; nevertheless the central bank cut interest rates. Public debt has attained a sustainable level, but the general government structural balance has been significantly negative. Unemployment increased slightly to an annual average of 9.9 %. Some progress was made in structural reforms such as improving schooling rates and further liberalising the energy sector. Such reforms need to accelerate to improve the functioning of the markets for goods, services and labour.

Turkey has a good level of preparation in acquiring the capacity to cope with the competitive pressure and market forces within the EU. The quality of education and gender equality in education needs particular attention. Efforts are needed to ensure the transparency of state aid and to remove constraints and exceptions in the area of public procurement.

6. BOSNIA AND HERZEGOVINA

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should now be seen in the context of the increased importance of economic governance in the enlargement process. In order to improve their economic governance, in 2015 the enlargement countries were asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina is **at an early stage in developing a functioning market economy, although some progress** has been made. In particular, steps have been taken to strengthen policy coordination and to improve the business environment, particularly on the ease of market entry and the granting of construction permits. Despite the setback from the spring floods, economic growth remained positive.

However, stronger and sustainable economic growth will require the development of a more dynamic private sector. This requires strong political support and the timely implementation of much-needed structural reforms.

In line with the ERP recommendations and the Reform Agenda and in order to support long-term growth, in the coming year Bosnia and Herzegovina should pay particular attention to:

→ increasing the quality of public finance, for example by providing for more fiscal space, in particular for capital investment;

→ improving its budget management framework;

→ taking steps to advance restructuring and privatisation and to improve the business environment.

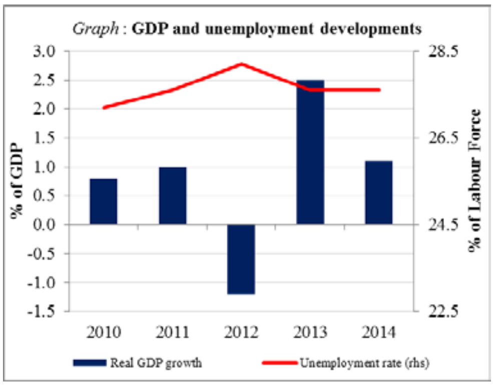
Economic policy essentials

The consensus on economic policy essentials has increased. A broad agreement has been reached on economic reforms, but the government now needs to show strong reform commitment by starting to implement the planned reforms. The consensus between the authorities at different levels of government on the economic policy essentials has broadly gained momentum with the adoption of the global framework for fiscal policies and balances 2016-2018 by the Fiscal Council.

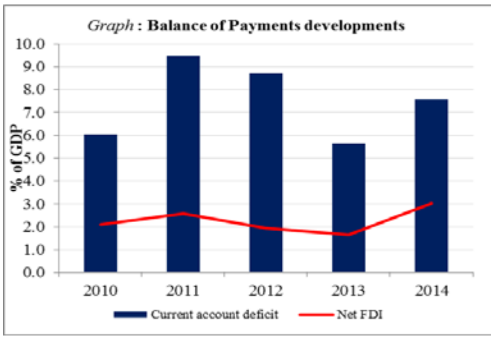
In February 2015, Bosnia and Herzegovina submitted its Economic Reform Programme covering the 2015-2017 period. The programme sets out an overly ambitious fiscal strategy based on reductions in expenditure but lacks initiatives that would stimulate growth. In addition, although some major obstacles for growth were identified, the structural reform strategy is vague on medium-term measures beyond 2015. There is ample room for improvement in terms of policy coordination. Following the adoption of the Reform Agenda in July, Bosnia and Herzegovina is encouraged to take further steps towards its implementation, including with the help of the ERP recommendations set out below, which reflect Reform Agenda priorities

The IMF Stand-By Arrangement (SBA), agreed in 2012, expired on 30 June 2015 but the last loan tranche disbursement was made in July 2014. The programme went off-track due to delays in implementation of previously agreed structural reforms. Negotiations for a new IMF programme have been ongoing.

Macroeconomic stability



Economic growth remained resilient in spite of external shocks. However, the short-term outlook will heavily depend on the implementation of structural reforms. After GDP growth of 2.4 % in 2013, substantial flood damages in mid-2014 reduced output growth to around 1 % in 2014. In contrast to 2013, it was domestic demand rather than net exports that drove GDP growth in 2014. Investment was stimulated by disbursements under the flood recovery programme (2.2 % of GDP by the end of 2014) and could remain important for economic growth in 2015. Investment in the private sector, however, continued to be stagnant. Private consumption growth remained subdued in 2014, reflecting persistently high unemployment and declining wages. Industrial production remained largely unchanged in 2014 but showed signs of increased activity from the second quarter 2015 onwards. However, a drought hit agricultural production in mid-2015 and could negatively impact on growth in 2015. Overall, data since early this year point to strengthening economic dynamics. Per capita GDP([1]) reached only 28 % of the EU average in 2014, largely unchanged since 2011.



External imbalances have declined recently. In 2014, strong import growth, partly resulting from reconstruction following the spring floods, pushed the current account deficit up from 5.7 % of GDP in 2013 to 7.6 % in 2014. However, strengthening exports since autumn 2014 and the fading out of reconstruction-related imports helped to bring the current account deficit back to 6.2 % of GDP in the first quarter of 2015. The substantial trade deficits of around 25 % of GDP are primarily financed by inflows of transfers, such as remittances, which increased to slightly above 11 % of GDP, and by service exports. Net foreign direct investments (FDI) rose from 1.7 % of GDP in 2013 to around 3 % of GDP in 2014. Partly boosted by IMF financial assistance, net foreign exchange reserves reached a level of some 30 % of GDP in mid-2015, covering more than six months' worth of imports.

([1]) Expressed in purchasing power standards.

Table 6.1:
Bosnia and Herzegovina - Main economic trends

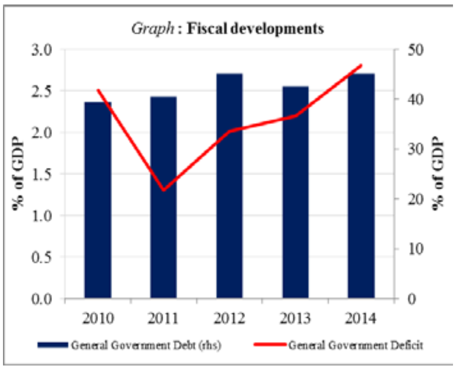
		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	0.8	0.9	-0.9	2.4	1.4	3.4
Private consumption	Ann. % ch	0.9	1.6	2.2	2.6	3.0	N.A.
Gross fixed capital formation	Ann. % ch	-12.2	6.8	6.3	-2.4	9.5	N.A.
Unemployment rate	%	42.7	43.8	45.9	44.5	43.6	43.0
Employment	Ann. % ch	1.9	-1.6	-0.4	0.6	2.7	1.5
Wages	Ann. % ch	1.1	4.4	1.5	0.1	-0.1	-0.1
Current account balance***	% of GDP	-6.0	-9.5	-8.7	-5.7	-7.6	-7.1
Direct investment (FDI, net)***	% of GDP	2.1	2.6	1.9	1.6	3.0	2.6
CPI, average	Ann. % ch	2.1	3.7	2.0	-0.1	-0.9	-0.5
Exchange rate BAM/EUR	Value	1.96	1.96	1.96	1.96	1.96	1.96
General government balance	% of GDP	-2.4	-1.2	-2.0	-2.1	-2.0	1.6*
General government debt	% of GDP	39.3	40.5	45.1	46.2	30.1 **	30.2**

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

Improvements in the labour market remained subdued so far. The difficult labour market conditions remained broadly unchanged. Employment in the public sector continued to account for the largest proportion of employment (32 %). At the same time, employment and activity rates remained at low levels of 43 % and 59 % respectively. The average rate of registered unemployment slightly decreased from 44.5 % in 2013 to 43 % in mid-2015, while results from the annual labour force survey (using ILO methodology) indicate that unemployment stood at 27.6 % in 2014 for a second consecutive year. The significant difference between the registered and survey-based labour figures points to a fairly large informal labour market. The structural nature of unemployment is reflected by the high proportion of long-term unemployment, accounting for around four-fifths of jobseekers. In addition, the already high youth unemployment figure increased to 63 % in 2014, as compared with 59 % in 2013. Furthermore, the enduring large differences between female and male participation rates (46 % and 72 % in 2014) suggest that labour market conditions remain especially adverse for women.

ERP recommendation 5: 'Reduce labour market rigidities by addressing disincentives to hiring, including taking further steps towards a reduction of the tax wedge while ensuring budget neutrality.'

Monetary policy remained in line with the overall economic development. Monetary policy continued to be conducted under a currency board arrangement with the euro as anchor currency and enjoys a high level of confidence and credibility. This approach has served the economy well so far. However, it also implies that the burden of adjustment to external shocks has to be accommodated by other policy areas, including fiscal policy. This requires a more responsible fiscal policy, necessitating the building-up of sufficient fiscal buffers and a stronger emphasis on medium-term stability. The overall price level continued to decline, although at a slower pace. In the first eight months of 2015, the overall index of consumer prices was 0.6 % lower than a year before. In July 2014, the decline had been -1.3 %. However, the main reason for the drop in the overall index was a marked decline in a limited number of commodities while prices for housing, health and education rose by some 1-2 %. Planned increases of energy prices in Republika Srpska in the second half of 2015 and stronger domestic demand are expected to lead to a higher overall price level.



The budget deficit increased in 2014 amid the persistently low quality of public finances. The suspension of disbursements of the last tranches under the IMF SBA and the emergency financing for the areas hit by flooding put heavy pressure on public finances in 2014, resulting in short-term financing solutions. The fiscal deficit in 2014 is estimated to have surged to close to 3 % of GDP, nearly tripling the target of 1.1 % of GDP set in the 2015-2017 framework for fiscal balance and policies. Public expenditure remained broadly flat at 46 % of GDP in 2014 and consisted mostly of current expenditure. Capital expenditure reached only around 4 % of GDP and is projected to decline to below 3 % in the coming years, contrary to ERP recommendation 2. Despite the adverse economic effects of the spring floods, revenues from indirect taxes showed positive growth in 2014. Measures to improve tax compliance, coupled with increases in excise duties on beer and tobacco contributed to stronger revenues. As a result, consolidated revenues are estimated to have remained broadly unchanged at 43 % of GDP in 2014.

ERP recommendation 2: 'Improve the composition of public spending to increase the fiscal space for capital investments by containing current expenditures through curbing the public sector wage bill and more efficiently allocating staff in the civil service at all levels of government. Take steps to better target social expenditures through extensive audits and finalisation of the establishment of the Single Registry of Beneficiaries of Cash Payments without Contribution in the Federation'.

Although important legal steps have been taken to improve the sustainability of fiscal policy, Bosnia and Herzegovina needs to do more to put these into practice, in line with ERP recommendation 1. The 2015 budgets of the Federation and the State government were adopted with considerable delay. Fiscal discipline in the Federation and its lower levels of government improved following the entry into force of the Law on Budgets in January 2014. However, so far the law is not implemented efficiently. In mid-September, the Republika Srpska adopted a law on fiscal responsibility, including establishment of an independent Fiscal Council and a fiscal rule limiting government expenditures and deficits.

ERP recommendation 1: 'Improve the budget management framework by adopting and implementing the Law on Fiscal Responsibility in Republika Srpska, especially including the establishment of a Fiscal Council and the adoption of a fiscal rule. Take steps to address obstacles to an efficient implementation of the Law on Budgets in the Federation, in particular the functioning of the Fiscal Coordination body. Continue with the improvement of expenditure controls, fiscal discipline, budget reporting methods and the efficiency of tax authorities of lower levels of government.'

The rapidly increasing public debt and related refinancing risks are sources of macroeconomic vulnerability. General government debt has steadily increased in recent years, reaching 45.1 % of GDP by the end of 2014. The repayment schedule for public debt is concentrated in the next few years, posing additional risk to fiscal sustainability given the tight fiscal space and lack of access to international capital markets. Debt service payments in 2014 soared to 5 % of GDP on the back of intensified issuing of short-term government securities to make up for the non-disbursement of tranches under the IMF SBA.

Interplay of market forces

Privatisation remained largely an unfinished task. The direct state influence on the economy has remained significant, with a total spending-to-GDP ratio of close to 45 % of GDP. The problem is less severe in Republika Srpska, where only a few large publicly owned companies remain. The privatisation process in the Federation, started in 1999, continued to suffer setbacks despite the adoption of privatisation strategies in 2014 and 2015. Attempts to sell 14 companies in 2014 were largely unsuccessful. This left the assets still to be privatised at two-thirds of the initial stock of state-owned capital for privatisation, underscoring the pressing need for an initial restructuring to kick-start the privatisation process, as underlined in ERP recommendation 3.

> **ERP recommendation 3:** 'Take steps to advance restructuring and privatisation and improve the efficiency and corporate governance of companies with state ownership, notably in the Federation, to relieve the substantial burden on public finances.'

Market entry and exit

Some progress was made to ease market entry and to facilitate the issuing of construction permits. However, progress has been uneven and uncoordinated across the entities. In 2013 and 2014, Republika Srpska carried out an ambitious set of reforms to reduce business registration time and costs. The Republika Srpska authorities also started a single registry for companies.

> **ERP recommendation 4: '**Take steps to continue with the set-up of registry of para-fiscal fees to relieve burden on businesses without endangering the sustainability of public finances. Continue to reduce costs of business entry and exit and simplify the regulatory framework for the issuance of construction permits, especially in the Federation.'

In the Federation, the adoption of amendments to the law on the default interest rate created conditions for companies to address arrears more effectively. In addition, both Entities announced the set-up of a registry of non-tax charges for end-2015, in accordance with ERP recommendation 4. Limited access to financing, slow contract enforcement and the high tax burden on labour have been identified as major disruptive factors for doing business in Bosnia and Herzegovina. No progress was made on the creation of a single economic space (ERP recommendation 7), nor on mutual recognition of business registration by the Entities (ERP recommendation 8).

> **ERP recommendation 7**: 'Take steps toward the establishment of a single economic space by addressing the lack of internal coordination across all government levels.'
>
> **ERP recommendation 8**: 'Improve the business environment and support private sector development, including through the mutual recognition of business registration. Develop measures to provide targeted support for SMEs and to widen their access to finance. Tackle all forms of corruption, fraud and money laundering and informalities in the economy.'

The legal system

Strengthening the rule of law, simplifying contract enforcement procedures and fighting corruption remain essential if Bosnia and Herzegovina's business environment is to improve. Although a few steps have been taken to improve the legal rules governing business, the situation remains complex and problematic. The country has a lack of institutional capacity and a poor track record, especially on settling commercial disputes. The enforcement of commercial contracts still takes a long time, involving 37 procedures, taking on average 595 days and costing 34 % of the claim value.

Financial sector development

The banking system is liquid and well-capitalised but burdened with a high level of non-performing loans (NPLs). The financial system continues to be dominated by the banking sector, which accounted for 87 % of total financial assets.

The number of banks declined to 26 after one bank filed bankruptcy proceedings in 2014; this increased the proportion of foreign-owned assets in the banking sector to over 90 %. There were only two majority state-owned banks, accounting for less than 3 % of the sector's assets. The rest is privately owned.

The capital adequacy ratio declined slightly to 16.3 %, remaining well above the regulatory minimum of 12 % at the end of 2014. Banking sector profitability recovered in 2014 after recording losses in 2013. Nevertheless, the credit risk indicators for the banking system raise concerns as the proportion of NPLs in total loans remained slightly above 14 % in the second quarter of 2015. Despite some recent progress, legislative changes to facilitate loan restructuring and NPL resolutions are still not in place. In order to strengthen the sector's resilience, Bosnia and Herzegovina needs to markedly step-up its efforts to encourage the clean-up of banks' balance sheets, as requested in ERP recommendation 6. Furthermore, the Central Bank's analytical capacities need to be strengthened. Credit growth remained feeble despite greater liquidity in the banking sector. The size of the non-banking sector, chiefly investment funds and insurance companies, increased somewhat: its assets increased slightly to 13 % of GDP in 2014, still below half of the pre-crisis period.

ERP recommendation 6: 'Finalise the development of a financial restructuring framework including to address the high burden of non-performing loans on bank balance sheets from both a stock and a flow perspective and thus help remove potential supply- and demand-side obstacles to credit extension. In this context, a strengthening of the crisis resolution framework would also appear warranted.'

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

Bosnia and Herzegovina is **at an early stage in achieving the capacity to cope with competitive pressure and market forces within the Union, although some progress** has been made, in particular on the liberalisation of energy markets. There were however no positive developments in the quality of education (a key driver of competitiveness). State influence on the economy remains significant and puts a persistent burden on public finances.

In line with the ERP recommendations and in order to support long-term growth, in the coming year Bosnia and Herzegovina should pay particular attention to:

→ developing a more strategic approach to tackling deficiencies in its training and education system; improving teacher training and, in turn, the basic and transversal skills of students.

→ simplifying its complex procedure for exports;

→ developing a transport strategy and an energy strategy.

Human and physical capital

Significant efforts are needed to improve the efficiency of the education system, in line with ERP recommendation 9. Education policy is not decided on at national level but at Entity level in the Republika Srpska and at cantonal level in the Federation. Despite recent efforts to increase coordination, the system remains very fragmented. Public expenditure for education is nearly 3.5 % of GDP, slightly below the regional average. The inefficient use of education spending leaves ample room for improvement. The low enrolment rates for tertiary education, despite an upward trend, are far below the regional average. The country should use its upcoming membership in the Advisory Group on European Qualifications Framework to develop and finalise its National Qualification Framework.

ERP recommendation 9: ‘Develop a more strategic approach to tackle the deficiencies in the training and education system by effectively prioritising measures based on a mapping of the skills gap taking into account the needs of industry, especially SMEs. Harmonise legislation and standards related to education and training at state and entity level, as well as at cantonal level, since the competence on education in the Federation is at cantonal level.’

There is a pressing need to attract private investment, in particular FDI, and to increase public spending on investments that stimulate growth. The spring floods in May 2014 affected large parts of the country, causing losses and damage of up to 15 % of GDP. Reconstruction advanced at a slow pace and only 20 % of the reconstruction funds pledged for the Floods Recovery Programme had been disbursed by March 2015. The investment-to-GDP ratio in 2014 remained relatively modest at 18 % of GDP. In addition, low public capital expenditure (below 4 % of GDP) is holding back improvements to physical infrastructure. On a positive note, net FDI inflows reversed their downward trend and increased to 3 % of GDP in 2014. The development of public-private partnerships and lending schemes to SMEs could further boost private investments.

Some progress has been achieved on unbundling electricity networks. Starting from 2015, Bosnia and Herzegovina formally liberalised its electricity market. However, legislative changes to the regulatory framework are still to be passed. On the other hand, hardly any progress has been achieved towards a more competitive telecommunications market. The three incumbent operators continue to act as *de facto* monopolies over fixed voice telephony in their geographical areas. The number of new registrations in the internet services and network operators market continued its upward trend in 2014. The energy and transport sectors need country-wide energy and transport strategies to help unlock their large potential in line with ERP recommendation 10.

ERP recommendation 10: ‘Develop a transport policy and strategy and an energy strategy at each level of government according to competencies, and embed them with the regional agenda on connectivity, including through the establishment of a credible planning of prioritised reforms with a timeline and funding mechanism (single project pipeline). The energy strategy should also consider substantial investments in a diversified power generation and on an effective distribution network.’

Sectoral and enterprise structure

The structure of the economy is dominated by services, while agriculture's share in the economy is the lowest in the region. The economy continued to be dominated by the services sector, which accounted for 67 % of gross value added in 2014. Industry accounted for the second largest share at 21 %, broadly unchanged over the last four years. Agriculture occupies the lowest share in value added by regional comparison (7.1 %), while the contribution of the construction sector remained around 4.5 %.

Micro-enterprises play a significant role in the economy. According to end of September 2014 figures from the Statistical Business Register, only 56.7 % of enterprises in Bosnia and Herzegovina were active. The majority (75.1 %) were micro-enterprises with less than 10 employees, operating mainly in wholesale and retail sales. The informal sector, which flourishes in the context of poor law enforcement and insufficient anti-corruption measures, is a major obstacle for industrial development and continues to impose significant costs on the overall economy.

State influence on competitiveness

State subsidies and guarantees remain significant and put a heavy burden on public finances. Limited progress has been achieved on reducing the state's influence on the economy. A large proportion of subsidies were granted to agriculture, while state guarantees were granted primarily to public enterprises in the infrastructure sector to keep them afloat. Budget subsidies to industry and agriculture decreased somewhat in 2014 to slightly below 1 % of GDP. Loan guarantees and transfers provided by the Entities to bankrupt public enterprises reached 7 % of GDP.

Economic integration with the EU

Trade integration with the EU fell slightly as a result of declining exports. Trade openness increased somewhat in 2014 to 91 % of GDP but still remains relatively low. The EU is by far Bosnia and Herzegovina's largest trading partner, accounting for 72.1 % of goods exports and 58.9 % of goods imports. The main export categories include low- to medium-tech manufactured goods, such as textiles and raw materials. The share of the EU-28 in total exports fell in 2014 due to a 20 % slump in exports to Croatia and a stagnation of exports to Germany, Bosnia and Herzegovina's main EU trade partner accounting for one-quarter of its total goods exports. Over the same period, imports from the EU increased by 4.8 %, mainly from Italy (+20 %) and Austria (+10 %).

> **ERP recommendation 11:** 'Simplify the complex procedures for exports, ensure coordinated border controls and improve the border infrastructure system. Develop a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU.'

The EU is also the major investor in Bosnia and Herzegovina, accounting for nearly 63 % of total FDI, with Austria and Slovenia accounting for the largest FDI stocks in 2013. Non-tariff barriers to trade with the EU remain a significant problem and require structural and regulatory reforms. Some positive regulatory steps were taken toward stimulating exports to the EU, in line with ERP recommendation 11. In June 2015, the EU Food and Veterinary Office approved all actions proposed by Bosnia and Herzegovina to meet standards for the production and processing of dairy products intended for export to the EU.

6.3. CONCLUSIONS

With regard to the economic criteria, Bosnia and Herzegovina is at an early stage in developing a functioning market economy. Some progress has been made on improving the business environment, particularly on easing market entry and the granting of construction permits. Despite the setback from the 2014 floods, economic growth remained resilient. However, difficult labour market conditions have remained largely unchanged, with unemployment at 27.6%, rising to 62.7% among youth. In order to tackle high unemployment and low participation rates the country should reduce labour market rigidities, including a reduction of the tax wedge. The quality and sustainability of public finances have deteriorated. The business environment remained weak, impeding a stronger economic recovery. The government needs to improve the quality of public sector governance, in particular by increasing fiscal space for growth enhancing capital investment. Furthermore, concrete steps are needed to improve its budget management framework, to advance privatisation and to improve the business environment.

Bosnia and Herzegovina is at an early stage in achieving the capacity to cope with competitive pressure and market forces within the Union. Some progress has been made on the liberalisation of energy markets. However, in order to strengthen the country's competitiveness, the authorities should pay particular attention to developing a more strategic approach to tackling deficiencies in its training and education system; simplifying its complex procedure for exports and developing a transport strategy and an energy strategy.

7. KOSOVO*

In line with the conclusions of the European Council in Copenhagen in June 1993, EU accession requires the existence of a functioning market economy and the capacity to cope with competitive pressure and market forces within the Union.

The monitoring of these economic criteria should be seen in the context of the increased importance of economic governance in the enlargement process. In order to improve their economic governance, in 2015 the enlargement countries were asked to prepare Economic Reform Programmes (ERPs), which set out a medium-term macro-fiscal policy framework together with key structural reforms aimed at supporting the framework and boosting competitiveness. The ERPs were the basis for country-specific recommendations jointly adopted by the EU and the Western Balkans and Turkey in the Economic and Financial Dialogue meeting on 12 May 2015.

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo is at **an early stage in developing a functioning market economy**. The pursuit of economic reforms received a new momentum after the post-election impasse. **Some progress** was made, particularly on facilitating business creation, improving the legal system and on financial sector stability. The persistent trade deficit reflects a weak production base and lack of international competitiveness. An inefficient public sector and ad hoc fiscal policy decision-making constitute significant fiscal risks. Reliance on remittances and widespread informal economy additionally decrease employment incentives resulting in low labour force participation, especially among women, high unemployment rates, in particular among young and unskilled workers. Kosovo should reduce reliance on customs duties by broadening domestic tax base and modernising revenue collection.

In line with the ERP recommendations and in order to support long-term growth, in the coming year Kosovo should pay particular attention to:

→ ensuring fiscal sustainability;

→ speeding up the privatisation and restructuring of publicly owned enterprises;

→ improving bankruptcy and insolvency procedures.

Economic policy essentials

The government's strategic documents show a strengthened commitment to pursuing economic reforms. This should be translated into determined policy implementation and an avoidance of ad hoc decision-making in economic policy. The 2014 post-election political impasse delayed the pursuit of sound economic policies, including the adoption of the 2015 government budget.

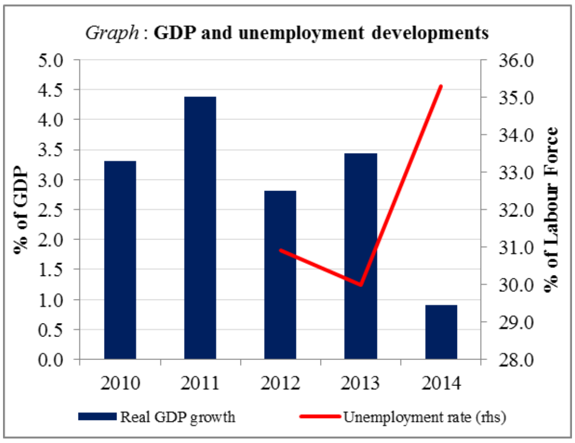
Kosovo submitted its first Economic Reform Programme (ERP) to the Commission in January 2015. Together with the new government programme, the ERP reflects a clear commitment to pursuing a stable fiscal policy and structural reforms to boost competitiveness.

(*) This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

Following the joint adoption of the ERP recommendations, the Kosovo government has started launching ERP-based reforms. A new EUR 184 million 22-month stand-by programme with the IMF has been approved in July 2015. The programme aims at strengthening the credibility of public finances, in line with ERP recommendation 1, further enhancing financial stability and boosting competiveness and productive capacity.

ERP recommendation 1: "Sustain the commitment to fiscal discipline and improve transparency of public finances by considering establishing an independent fiscal council, or fiscal agency, with a clear mandate to preserve sustainability of public finances, and reduce deficit bias, and by better coordination between government and parliamentary bodies responsible for budgetary processes. Improve the budget process by legislatively strengthening the role of the Medium Term Expenditure Framework and enshrine principles of cost-benefit analysis as the basis of the policy planning process. Take steps to increase government deposits to the threshold implied by the fiscal rule (4.5 % of GDP) to provide additional financing buffer."

Macroeconomic stability



The macroeconomic situation remained stable but challenging, having been hit by the political uncertainties in 2014. Preliminary data shows that economic growth in 2014 dropped to 0.9 %, below the ten-year average of 3.5 %, as a result of political impasse which caused delays in capital investments. Economic growth was mainly driven by private consumption (1.2pp contribution to growth) resulting from higher remittances and increased pensions and wages in the public sector. Net exports continued to weigh on GDP growth (-1 pp). Production capacity is poorly developed. Trade and real estate activities continued to positively influence growth while construction contracted. Preliminary results for Q1 2015 show further growth slowdown, possibly influenced by the migration outflows at the beginning of the year.

External imbalances worsened slightly in 2014, despite the continued economic recovery in Kosovo's main trading partners and diaspora countries. In 2014 the current account deficit increased to 8 % of GDP, after having fallen since 2011. This increase resulted from weaker transfers to the government from abroad caused by delays in ongoing projects due to the political impasse. Growing remittances (12.6 % of GDP in 2014) continued to offset the traditionally high trade deficit (31.6 % of GDP in 2014). The inflow of foreign direct investment (FDI) amounted to 2.6 % of GDP, the lowest in the last ten years, which averaged 6.7 % of GDP. The bulk of financial inflows was informal and unrecorded (5 % of GDP). Kosovo's external debt remained relatively low at 31.6 % of GDP in 2014 and is not a cause for immediate concern.

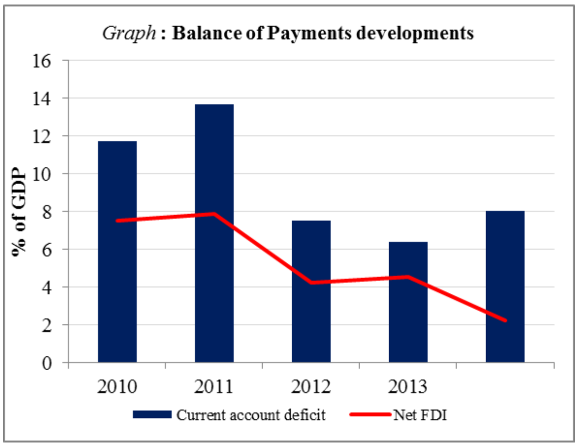


Table 7.1:
Kosovo - Main economic trends

		2010	2011	2012	2013	2014	2015 H1
Gross domestic product	Ann. % ch	3.3	4.4	2.8	3.4	0.9	0.2*
Private consumption	Ann. % ch	3.5	3.5	2.9	2.0	1.3	2.6*
Investment	Ann. % ch	10.9	7.8	-12.9	-0.3	1.5	-2.5*
Unemployment rate	%	N.A.	44.8	30.9	30.0	35.3	N.A.
Employment	Ann. % ch	N.A.	N.A.	N.A.	1.4	-4.4	N.A.
Wages	Ann. % ch	-13.1	-1.3	-3.0	-5.5	N.A.	N.A.
Current account balance**	% of GDP	-11.7	-13.7	-7.5	-6.4	-7.9	-3.5
Direct investment (FDI, net)**	% of GDP	8.4	8.0	4.5	5.3	2.7	1.4
CPI, average	Ann. % ch	3.5	7.3	2.5	1.8	0.4	-0.4
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
General government balance	% of GDP	-2.6	-1.7	-2.6	-3.1	-2.2	N.A.
General government debt	% of GDP	5.9	5.3	8.1	8.9	10.6	11.2

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

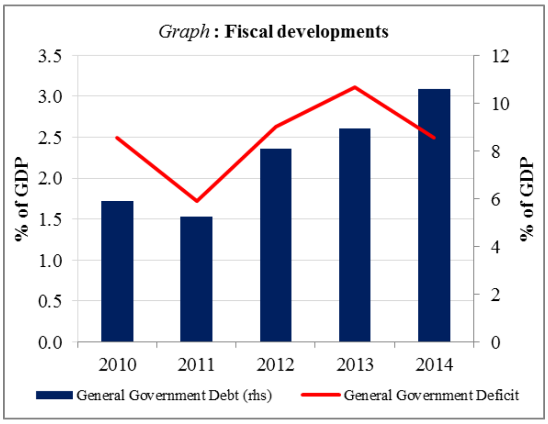
Employment is extremely low and efforts to improve labour market conditions have been limited. Moderate economic growth over recent years has not translated into a better performance by the labour market. Kosovo has the lowest employment and activity rates in Europe (26.9 % and 41.6 % respectively); this is due to a weak production base and low competitiveness in human capital and labour costs. Reliance on remittances and widespread informal economy additionally decrease employment incentives.

The unemployment rate increased to 35.3 % in 2014 from 30 % in 2013. Labour market conditions are especially difficult for women. Only one in five women of working age were active in the labour market and only one in eight were employed. Limited job opportunities, especially for young people (61 % youth unemployment), are also putting a strain on social cohesion and encouraging emigration. Financing for active labour market policies remains fragmented and insufficient. Labour market statistics have remained inadequate and more harmonised data is needed in order for Kosovo to be able to make informed policy choices.

Inflation is mainly dependent on import prices, specifically food and energy prices. The consumer price index inflation in Kosovo has been on a downward trend since 2011, reaching 0.4 % on average in 2014 and declining further to -0.7 % by July 2015.

ERP Recommendation 2: "Address immediate fiscal risks with necessary measures aimed at reducing unsustainably high current expenditures while preserving growth enhancing capital spending. Develop a legal framework for maintaining a sustainable public wage bill and strengthen targeting and means testing of transfers. Ensure planned increases in agricultural subsidies are directed exclusively at productivity increasing initiatives. Advance public administration reform with special attention on improving productivity and reducing costs. Take further steps in strengthening public finance management practices."

The execution of the 2014 budget was characterised by lower-than-expected revenues and ad hoc pre-election spending increases. The 2014 budget was the first budget to be subject to the new 2 % of GDP deficit fiscal rule. As a result of the April 2014 government increase in salaries, pensions and benefits, current expenditures accounted for a higher proportion of total spending at 71.3 % in 2014 compared with 63.5 % in 2013. In addition, the caretaker government committed roughly 32 % of the overall capital spending in the next four years to highway construction, thus further limiting fiscal space in the following years. Overall expenditure underperformed by 11 % compared to the plan. This decrease was due to delays in public investments.



Budget revenues underperformed by 12 %; this is due to lower-than-expected growth and the postponement of some one-off transfers. Kosovo needs to take further measures to improve revenue collection in line with ERP recommendation 3. The overall fiscal deficit stood at 2.5 % of GDP, higher than the fiscal rule threshold of 2 %. Considering however the exceptions allowed by the rule, the 2014 budget can be considered to be in conformity with it. The breach of fiscal rule was in any case only avoided due to under execution of capital spending.

ERP Recommendation 3: "Modernize revenue collection to reduce reliance on customs receipts by improving property tax collection and strengthening the legal framework for collection of tax and municipal tax arrears. Revisit local government grant financing scheme to incentivise better collection of municipal revenues. Further broaden tax base by introducing the planned mandatory health sector contributions, and reassess planned tax exemptions."

Total public debt continued to increase, reaching 10.6 % in 2014. An increasing proportion of this comes from domestically issued treasury bills. Kosovo has a relatively low level of public debt. However, given its reliance on short-term domestic financing and loans from international financing institutions and its inability, in the absence of a credit rating, to issue international debt, prudent fiscal policy is crucial for Kosovo. Government deposits, maintained as an emergency source of financing, fell steadily to 1.8 % of GDP at the end of 2014, substantially below the 4.5 % threshold suggested by the fiscal rule.

Due to the post-electoral political deadlock, the 2015 budget was adopted only in December 2014 and it was based on overly optimistic revenue projections (18.3 % rise compared to 2014 budget execution). In the July mid-term budgetary review both revenue and expenditure targets were adjusted, now standing, still ambitiously, 14.1 % and 11.5 % higher than the 2014 budget execution. By July 2015, revenues grew by 9.3 % compared to the same period in 2014 thus lagging behind the plan. To increase revenue, the government has introduced changes to excise duties and the VAT system applicable from 1 September 2015.

Successful reforms in the customs administration directed at better goods evaluation and fighting smuggling yielded a 7.4 % increase in border revenues compared to the first seven months in 2014. Spending is also lagging behind the budget plan, again mainly due to underperformance of capital spending. Without further improvements in revenue collection or additional expenditure cuts, satisfying both the fiscal rule deficit and capital spending targets will be difficult.

The fiscal rule and the law on public finance form the backbone of public finance management in Kosovo. However, their enforcement and monitoring mechanisms need to be improved. Repeated ad hoc fiscal decision-making, with a large fiscal impact is the main risk to fiscal sustainability. Budget planning procedures have not been transparent and coordinated so far, and budget spending programmes are not joined up with the government's long term priorities. The launch of a central procurement system and better checks on contracting procedures at the local level are welcome steps, but more needs to be done to meet ERP recommendation 2.

Interplay of market forces

> **ERP Recommendation 4: "**Advance restructuring and restart the privatisation of non-essential Publicly Owned Enterprises (POEs). Take steps to improve the efficiency and corporate governance of strategic POEs. Address the lack of quorum of the board of Privatisation Agency of Kosovo (PAK) and accelerate privatisation of Socially Owned Enterprises still in PAK's portfolio."

Overall, very limited progress was achieved in the privatisation and liquidation of publicly owned enterprises. No new privatisations took place. The privatisation agency remained dysfunctional and its credibility was further tarnished amid political controversy and corruption allegations. The privatisation agency still does not have a new, credible, independent and functioning board; its merit-based management selection procedures and anti-corruption mechanisms need to be strengthened in line with ERP recommendation 4. The unresolved status of property rights and lengthy legal proceedings in dealing with financial claims on privatised assets hinder the privatisation process and delay disbursement of privatisation revenue held at the central bank.

Among centrally-managed enterprises, only two, the Kosovo Energy Corporation and Post and Telecommunications Kosovo, continued to generate a profit in 2014. Government influence on price controls for utilities and postal and telecommunications services has continued.

Market entry and exit

> **ERP Recommendation 5:** "Address the underlying causes for high costs of bank-based financing, reduce the duration and cost of insolvency procedures by adopting the new bankruptcy law and further improve contract enforcement with a view to increase overall financial intermediation in the economy."

Some progress was made in simplifying business registration, but insolvency procedures still present an obstacle. The establishment of one-stop shops in 2014 has reduced the time needed for company registration down to three days. However, the announced online registration has still not been fully implemented. Numerous obstacles to market entry remain: a weak and unaccountable administration; insufficient access to finance; an underdeveloped infrastructure (especially in electricity supply); a deficient rule of law; extortion practices; a widespread informal economy; and insufficient academic and professional/vocational education. Weak insolvency procedures still hinder market exit and delay payments to creditors. A draft law on bankruptcy needs to be approved in line with ERP recommendation 5.

Legal system

Despite some progress made on the legal rules governing business, their implementation has remained insufficient. Very weak institutional capacity for legal enforcement combined with widespread corruption continued to hinder the business environment. The judicial system suffers from poor accessibility, inefficiency, delays and a growing backlog of unresolved cases (400 000 in July 2015). The politically influenced appointments of judges and prosecutors limit the independence of the judiciary. More work is needed on reviewing the civil code on business lawsuits and practices and on developing register (cadastre) databases, in line with ERP recommendation 8.

Financial sector development

Financial sector stability was maintained and credit growth picked up pace. The steady credit growth in Kosovo's banking sector rebounded in 2014 (4.2 % increase) and continued to grow in 2015. Kosovo's financial system remains dominated by the banking sector (69.5 % of the total financial sector assets). The stability of the banking sector was strengthened, with the proportion of non-performing loans fully covered by bank provisions falling to 7.1 % (July 2015). Private loan enforcement agents established at end 2014 contributed to the NPL decline. The improved profitability of banks in 2014 (131.1 % rise in profits) further strengthened their capital buffers to 19 %, which is substantially above regulatory requirements. Although total lending grew, a still relatively low loan-to-deposits ratio (74.3 %) means that there is ample room for stronger banking activity. Average loan interest rates fell below 10 % for the first time, but have remained above the regional average.

The insurance sector is dominated by non-life insurance companies. The cost of car insurance is artificially high, due in part to Kosovo not being a member of the 'green card' system, but also to it not having fully liberalised third party liability insurance prices.

The Central Bank of Kosovo continued to improve the SWIFT infrastructure for international payments which is accessible and used by all banks. Since February 2015, banks in Kosovo have been using IBAN for international payments.

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

Kosovo is **at an early stage in achieving the capacity to cope with competitive pressures and market forces within the Union**. **No progress** was made on improving the quality of education, which is a key driver for improving long-term growth and competitiveness.

In line with the ERP recommendations and in order to support long-term growth, in the coming year Kosovo should pay particular attention to:

→ securing a stable energy supply and reducing distribution losses;

→ closing the skills gap in the labour market;

→ channelling foreign direct investments and remittances into productive sectors.

Human and physical capital

No progress was made in improving the quality of education. Increases in public spending on education (up to 4.4 % of GDP in 2014 with 4.6 % planned for 2015) have so far been used almost entirely to cover salary increases. More funding should be directed to other aspects of education reform, as referenced in ERP recommendation 7. The establishment of the Agency for Vocational Education and Training and Adult Education (VET) should help to address the evident skills mismatch in the labour market.

ERP Recommendation 7: "Improve the quality of education by continuing to roll out teacher licencing and training as well as improving quality assurance and strengthening related incentives; improve access to pre-primary and primary school education; accelerate modernisation of vocational education, continue improve quality of higher education and improve focus on aligning the education system so as to make it more responsive to the labour market. Assure the timely operationalisation of the recently established Public Employment Service and its effectiveness in lowering the high unemployment rate."

Nevertheless, the unemployment rate among vocational graduates is 71 %. Insufficient funding, a low level of cooperation between vocational schools and businesses and delays in implementing policies remain major concerns.

Kosovo made some progress on improving physical capital, but road investments clearly dominate over energy efficiency and water distribution. In 2014, total investment continued to fall, reaching 26.2 % of GDP. Government capital spending agenda is dominated with road building, namely the construction of the Route 6 highway to Skopje. ERP recommendation 6 deals with ways of improving the assessment of major infrastructure projects.

Lack of reliable energy supply is still seen as one of the biggest obstacles to investment growth. Investments in the electricity network have improved network stability and reduced technical losses. Construction has started on the new 400kV transmission interconnector to Albania and the district heating project at the Kosovo B power plant. Negotiations with the only bidder for the construction of the new modern power plant are stalled.

ERP Recommendation 6: "Strengthen government oversight and consider setting up an advisory body to contribute to the assessment of future major infrastructure projects, including their fiscal impact and make sure they align with the regional agenda on connectivity (core network). Advance towards securing a reliable energy supply while ensuring the compliance with the EU environmental standards in the production of energy."

Almost all incoming foreign direct investment went to the non-tradable sector, in particular real estate and financial intermediation. However, a EUR 409 million contract for investment in the Brezovica ski resort was signed in April. Work is due to start in the following months and is expected to provide around 3 000 new jobs.

Sectoral and enterprise structure

Kosovo's private sector continues to be fragmented and unable to benefit from efficiency gains, as micro-, small- and medium-sized enterprises account for 99 % of total employment. Although still above its regional peers, the share of agriculture in Kosovo's GDP fell to 11.4 %, compared with 14.1 % in 2009, while the share of services rose from 47 % to 49.2 % of GDP. Shifts in the employment structure away from agriculture and towards services are evident. This is in line with expected developments as part of Kosovo's transition towards a modern services-oriented economy.

The structure of operating enterprises is dominated by trade (29.9 % of operating enterprises), followed by accommodation and food services (11 %) and industry (10.4 %, up from 5.2 % in 2013). Productivity gains are limited by poor access to broader markets and a lack of investments in new technologies. Kosovo should improve its business environment, in line with ERP recommendation 8.

ERP Recommendation 8: "Continue to improve the business environment and continue with the clearing of court backlogs, strengthening capacities of judicial system, and developing cadastre databases. Advance measures to tackle informality in line with the strategy for the prevention and fight against informal economy, including incentives to reduce undeclared work. Reduce the administrative burden for business by implementing the Better Regulation Strategy and the Law on Permits and Licences. Develop measures to provide targeted support for SMEs and to widen their access to finance. Step up the fight against corruption and efforts to improve public procurement, by enhancing administrative capacity, increasing efficiency and effectiveness of the Public Review Board, and implementing central procurement."

State influence on competitiveness

There was no progress on developing institutional capacity to check state aid and subsidies are still being provided without a proper strategy and evaluation. Publicly owned enterprises in the energy, transport and waste/water sectors continued to be subsidised. New subsidies and direct payments to agriculture were introduced. These need to be more closely linked to increasing productivity. Tax and customs exemptions were introduced for certain sectors (agriculture, IT), but without a clear impact assessment.

The authorities continued to establish economic zones and industrial parks. However, this was done without a national plan (which was a legal requirement) and without transparent disclosure of tax and customs incentives approved to companies.

Economic integration with the EU

The EU is Kosovo's biggest trade and investment partner. However, Kosovo's export capacity remains limited. Kosovo's economy is still relatively unintegrated in global trade flows, with a trade openness of 71.1 % of GDP. However, the value of Kosovo's goods trade with the EU has been rising continuously since 2008, standing at 41.2 % of overall trade in 2014.

In spite of that increase, Kosovo's total trade volume with the EU remains very limited (EUR 98.08 million in exports and EUR 1.08 billion in imports in 2014), reflecting the low competitiveness of its products and other structural obstacles hindering this potential. The Central European Free Trade Agreement (CEFTA) countries remained Kosovo's second largest trade partner (29.6 % of total trade).

EU countries are the biggest foreign investors in Kosovo (35 % of overall investment). The planned entry into force of Kosovo's Stabilisation and Association Agreement with the EU is expected to further incentivise economic ties with the EU countries. Kosovo will, however, need to continue with reforms in order to facilitate trade and foreign direct investment, in line with ERP recommendations 9 and 10.

ERP Recommendation 9: "Facilitate trade by amending the Customs Code and adopting new legislation on customs enforcement of IPR."

ERP Recommendation 10: "Adopt a holistic approach to Foreign Direct Investment that anchors supportive policies in a strategic framework and focus on removing existing obstacles. Increase investor protection by developing an investor after-care program and establish an investor grievance mechanism."

7.3. CONCLUSIONS

As regards the economic criteria, Kosovo is at an early stage in developing a functioning market economy. The persistent trade deficit reflects a weak production base and lack of international competitiveness. Reliance on remittances and widespread informal economy decrease employment incentives contributing to already low labour market participation and high unemployment, which stands at 35.3%, rising to 61% among youth. Inefficient public administration and an ad hoc approach to fiscal policy constitute significant fiscal risks. Kosovo should strengthen the medium-term fiscal framework, improve the transparency of public finance and shift budget expenditure towards growth. Kosovo should also speed up privatisation and restructuring of public enterprises and improve bankruptcy and insolvency procedures, as well as reduce reliance on customs duties by broadening domestic tax base and modernising revenue collection.

Kosovo is at an early stage in achieving the capacity to cope with competitive pressures and market forces within the Union. Major reforms are still needed to secure a stable energy supply and reducing distribution losses, close the skills gap in the labour market, and channel foreign direct investment and remittances into productive sectors.

ABBREVIATIONS

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

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