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Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2019
Assessments

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European Commission
Directorate-General for Economic and Financial Affairs

Progress towards Meeting the Economic Criteria for EU Accession

The EU Commission's 2019 Assessments

ABBREVIATIONS

BiH	Bosnia and Herzegovina
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ERP	Economic Reform Programme
EU	European Union
EUR	Euro
FBiH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IDF	Investment Development Fund
IFIs	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
LFPR	Labour Force Participation Rate
LFS	Labour Force Survey
NPLs	Non-performing loans
OECD	Organisation for Economic Co-operation and Development
PISA	Programme for International Student Assessment
PRB	Procurement Review Body
RS	Republika Srpska
SAA	Stabilisation and Association Agreement
SBA	Stand-by Arrangement
SMEs	Small and Medium sized Enterprises
SOEs	State-Owned Enterprises
UNSCR 1244	United Nations Security Council Resolution 1244

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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 European Commission's country reports for the seven enlargement countries Albania, Bosnia and Herzegovina, North Macedonia, Kosovo(*) , Montenegro, Serbia and Turkey. The annual country reports assess progress achieved in each of the countries in advancing the necessary political and economic reforms as well as the legal transformation in line with the EU accession criteria. The European Commission adopted the country reports on 29 May 2019 as part of its 2019 Enlargement Package. ⁽¹⁾

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 2019 reports, i.e. the Commission staff working documents ⁽²⁾ for each of the countries.

The methodology of the 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 Country 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.

(1) This year, for Bosnia and Herzegovina, the text follows a slightly different, more extended format, since it forms part of the so-called "Opinion" on the country's application to join the EU.

(2) http://europa.eu/rapid/press-release_IP-19-2752_en.htm

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 EU.

Economic governance has become even more important in the enlargement process in recent years. The Commission's monitoring involves two processes: the economic reform-programme process, and the assessment in the pages below of compliance with the economic criteria for accession. Each enlargement country prepares an economic reform programme (ERP) every year, which sets out a medium-term macro-fiscal policy framework and a structural-reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU, the Western Balkans and Turkey at ministerial level in May each year.

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania has made **some progress** and is **moderately prepared** in developing a functioning market economy. Economic growth increased further and unemployment decreased even though it remains high. Exports grew solidly and the current-account deficit narrowed. The high public-debt-to-GDP ratio continued to fall. The stability of the financial sector improved, as banks continued to reduce non-performing loans. However, lending to the private corporate sector remained muted and the high use of foreign currency in the domestic market persisted. Steps have been taken to develop the non-banking financial market. The comprehensive judicial reform advanced well, but shortcomings in the rule of law continued to hamper businesses and deter investment. The business environment has only improved in some areas, and while formal employment grew, informality is estimated to have remained high. The liberalisation of the energy sector progressed, albeit with some delays.

In order to improve the functioning of the market economy, Albania should in particular:

- advance fiscal consolidation and developing a plan to mobilise revenue and to address informality;
- ensure monitoring and control of fiscal liabilities stemming from Public-Private Partnerships and of arrears;
- improve access to finance by strengthening collateral enforcement and raising financial inclusion;
- improve the labour market relevance, quality and targeting of active labour market policies, including upskilling of adults.

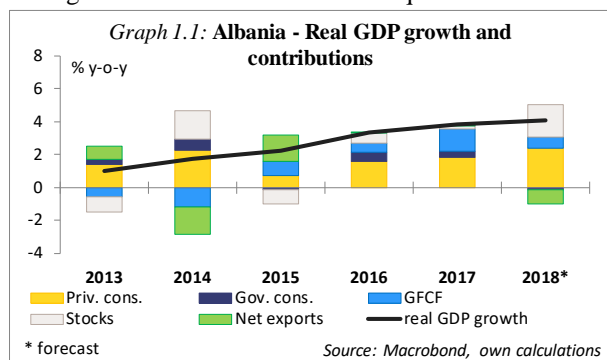
Economic governance

Albania remained committed to strengthening macroeconomic stability and fiscal consolidation. The government continued to reduce the still-high level of public debt at a faster pace than originally planned due to the appreciation of the currency and underspending on the budget. Reforms to the management of public finance have progressed with EU support. However, administrative restructuring following national elections has negatively affected overall capacity in the public administration. It remains a challenge to create a stronger link between the budget process and policy-making, and this challenge affects expenditure planning. The budget for 2018 was published and adopted in time, and consultations with civil society groups for the preparation of the 2019 budget had also started in time. The policy guidance jointly agreed at the May 2018 ⁽³⁾ Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented.

⁽³⁾ Western Balkans and Turkey: Joint conclusions of the economic and financial dialogue, 2018, <https://www.consilium.europa.eu/en/press/press-releases/2018/05/25/western-balkans-and-turkey-joint-conclusions-of-the-economic-and-financial-dialogue/>

Macroeconomic stability

The Albanian economy has continued to expand, thanks to both domestic and foreign demand. Annual real GDP growth, averaging 2.2 % between 2010 and 2015, accelerated to 3.8% in 2017, and averaged 4.2% in the first three quarters of 2018. In 2018, all components of domestic demand



contributed positively to output expansion. Private consumption was the main driver, supported by rising employment and low rates of interest and inflation. The contribution made by net exports to GDP growth remained negative in 2018, as high imports offset the recovery in goods exports. Despite strong economic growth and rising employment, per capita GDP (at purchasing power parity) stood at only 29% of the EU-28 average in 2017, representing a very slow pace of convergence.

The high current-account deficit continued to narrow, and was financed by foreign direct investment (FDI) inflows. Albania has historically run a large trade deficit in goods, which has recently widened due to exceptional FDI-related imports. The goods trade deficit was partly offset by a surplus in the balance of services, which benefited from: (i) strongly increasing revenues from foreign tourism between 2016 and 2018; and (ii) an even stronger increase in the contribution of manufacturing services. The real-effective-exchange-rate index (REER) climbed 9% by the end of 2018, reflecting the recent acceleration in the appreciation of the Albanian currency.

Table 1.1: Albania - Key economic figures	2010-15 average	2016	2017	2018
GDP per capita (% of EU-28 in PPS)	30,4	31,2	31,7	32,2
Real GDP growth	2,2	3,4	3,8	4,1
Economic activity rate of the population aged 15-64 (%), total	62,9*	66,2	66,8	68,3
female	53,2*	58,3	57,7	59,7
male	72,8*	74,1	75,8	76,9
Unemployment rate (%), total	16,4**	15,6	14,1	12,8
female	14,7**	14,6	12,8	12,3
male	17,7**	16,4	15,1	13,2
Employment (annual growth %)	1,5	6	2,7	2,1
Nominal wages ¹ (annual growth %)	5,2	-0,8	3,0	:
Consumer price index (annual growth %)	2,2	1,3	2,0	2,1
Exchange rate against EUR	139,5	135,2	133,0	123,4
Current account balance (% of GDP)	-11,6	-7,6	-7,5	-6,6
Net foreign direct investment, FDI (% of GDP)	8,6	8,8	7,8	7,9
General government balance (% of GDP)	-4,0	-1,8	-2,0	-1,5
General government debt (% of GDP)	64,7	72,3	70,0	67,3

Source: Eurostat and national sources

Notes: * 2014-2015

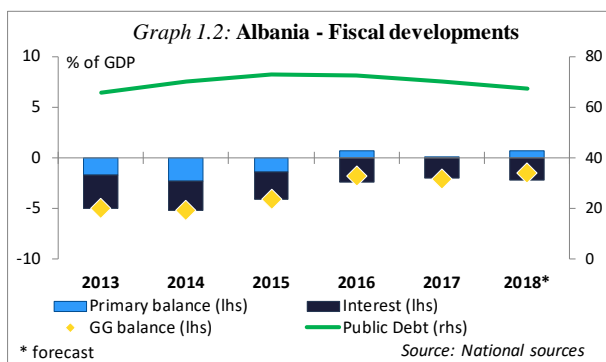
** 2013-2015

¹ average gross monthly wages

Overall, the current-account deficit fell considerably, dropping to 6.3% of GDP in 2018 from its 2010-2015 average of 11.6%. This decline in the current-account deficit was helped by larger remittances and rising exports of both goods and services. Both remittances and FDI recorded a slightly decreasing share in GDP: remittances fell to from 5.8% in 2015 to 5.2% of GDP in 2018, while FDI softened from 8.6% to 7.9%, as the construction of two large energy projects is nearing completion. Foreign reserves continued to cover 6.5 months of imports and 37% of total external debt in 2018, providing an adequate safeguard against adverse shocks.

Persistently below-target inflation and the rapidly strengthening currency prompted further monetary easing and foreign-exchange interventions by the Albanian central bank. The freely floating exchange rate of the Albanian lek appreciated by about 7.2% against the euro by the end of 2018. In the middle of the year, the central bank began to intervene on the foreign-exchange market to contain this appreciation. Average annual inflation has been below the central bank’s 3% target since 2013. Food prices pushed the inflation rate upwards, but lower import prices due to the stronger lek meant that overall inflation only increased slightly, rising to 2.2% in 2018 from 2.0% in 2017. The Albanian central bank, the Bank of Albania, has therefore maintained a very accommodative monetary policy by lowering the key policy rate (the repo rate) to a record low of 1% in July. The monetary-policy stance effectively supported price stability in line with the policy framework.

The government’s fiscal deficit is now 50% below its 2010-2015 average. The general government deficit fell to 2.1% of GDP in 2017 from 4.1% in 2015. Based on preliminary data, the 2018 budget has turned out with a deficit of 1.5% of GDP, lower than the initially targeted 2% of GDP. This lower-than-expected deficit is mainly due to ambitious plans for capital expenditure that were not fully implemented. The successful clearance of arrears in 2014 under the IMF programme accounted for most of the deficit reduction in 2015/16. However, the last 3 years have seen lower expenditure and higher revenues, both of which helped to



lower the deficit. At the same time, new arrears emerged due to: (i) weaknesses in budget planning and implementation; (ii) policy-coordination issues between government levels (local-government arrears); and (iii) slow tax-refund procedures (arrears of VAT refunds). A broader tax base, reduced informality and an increase in social contributions from increased formal employment helped to increase revenue. The recent multiplication of VAT exemptions will complicate attempts to broaden the tax base and improve the efficiency of tax collection. Overall, tax revenues remain far below potential. This is mainly due to informality but also due to tax evasion in the formal economy.

At 67.3% of GDP, public debt remains high. This high debt level could be unsustainable in case of an adverse shock to the economy. Supported by the appreciation of the lek, the gross-public-debt-to-GDP ratio declined to 67.3% at the end of 2018.⁽⁴⁾ The government successfully placed a EUR 500 million seven-year eurobond in October 2018. This helped to reduce the still-high annual rollover needs, and reduce the pressure by government financing on the domestic local-currency debt market.

Public financing is not sufficient to bridge the large infrastructure gap, so the government is seeking to mobilise private capital - mainly through public-private partnerships (PPPs). Public investment grew on average 6.2% per year in 2013-2018, and accounted for about 18% of total public expenditure on average. The increasing reliance on PPPs generates contingent liabilities and therefore fiscal risks. The newly established Fiscal Risk Unit does not have sufficient capacity to monitor these

⁽⁴⁾ The Albanian government includes its loan guarantees fully in its public debt calculation, and uses the IMF GDP forecast to calculate the debt-to-GDP ratio.

risks. Infrastructure financing could be made more efficient by taking advantage of the potential for synergies in the planning and execution of both PPPs and conventional public investment.

The overall macroeconomic policy mix has been broadly appropriate, and Albania has complied with fiscal rules. The main fiscal rule — to keep the public-debt-to-GDP ratio declining until the limit of 45% is reached — has been complied with. Budget implementation and public financial management (PFM) should be strengthened to avoid arrears and manage fiscal risks. Increasing tax revenues could help speed up the path to the 45%-debt-to-GDP limit, thus strengthening debt sustainability. Maintaining a loose monetary-policy stance has been appropriate for promoting a sustained rise in inflation towards the 3% target.

Functioning of product markets

Business environment

Albania's competitiveness and private-sector development remained below potential, as efforts to improve the business environment had poor results. Growth in the number of active domestic enterprises slowed from 5.5% in 2016 to 1% in 2017, with the number of newly established enterprises in 2017 about half that of 2015. Similarly, the number of foreign enterprises in industry and construction in 2017 actually declined compared to 2015, as did the number of greenfield investments. However, in the services sector and in agriculture, foreign enterprises grew strongly in 2017 compared to 2015. Major concerns raised by the business community include a lack of effective implementation of legislation, ad hoc regulatory changes, cumbersome tax payment procedures, and the controversial use of public-procurement procedures. Consultation with the private sector is ineffective. In addition, the development of a proper real-estate market has been held back by the lack of a cadastre and the problem of land titles that are burdened by ownership conflicts. This has been a particular hindrance to investment in agriculture and tourism.

Although judicial and institutional reforms continued, ineffective regulation and informality continue to pose major challenges for businesses. Progress has been made on judicial reforms, but this has not yet resulted in a more favourable business environment. The new Bankruptcy Law still awaits the adoption of accompanying regulations, and the implementation of the amended Private Bailiffs Law is hampered by disputes over fee schedules and the selection of bailiffs. In addition, corruption remains a widespread problem. In spite of measures taken to address the informal economy, it is estimated to account for about one third of GDP. This is causing losses in tax revenue, a lack of labour protection and unfair competition among firms.

State influence on product markets

State involvement and public subsidies remained overall low in the Albanian economy, but the increased reliance on PPPs raises the potential of state influence in certain markets. The government has increasingly engaged in PPPs, in particular for energy and transport, where there are price or volume agreements for services and goods. Government payments under these contracts are by law limited to 5% of the previous year's tax revenue, and for 2018 this limit has reportedly been complied with. Most of the existing PPP contracts were selected on the basis of unsolicited proposals, which reduce competition in procurement. It is welcome that the ongoing review of the procurement guidelines for these projects proposes to restrict the use of unsolicited proposals. Although the procurement legislation has recently improved, the implementation of public procurement remained flawed and continued to be perceived as not being transparent. The reported state aid granted in Albania between 2014 and 2017 was estimated at about 0.7% of GDP annually. In 2017, it was reported that 0.14% of GDP was spent on state aid, amounting to EUR 16.88 million, an increase on the EUR 12.7 million spent on state aid in 2016. Most of this EUR 16.88 million was spent on grants (about 77%) and tax exemptions (about 23%). Reportedly, most state aid goes to public services.

Privatisation and restructuring

The private sector remained dominant in the economy, but although overall market liberalisation is well advanced in Albania, there are delays in the liberalisation of the energy market. About 19% of assets in the Albanian economy in 2017 were owned by the state. State involvement in the economy is concentrated in electricity, with state-owned enterprises providing around three quarters of the electricity used in the country. State-owned enterprises are also active in other public utilities, such as railways, water supply and natural resources. Albania has moved ahead with separating the production, purchasing and distribution of electricity. However, the functional unbundling of the distribution-system operator from generation operators has not been completed. Restructured public electricity companies face difficulties in freely accessing the market, and electricity prices for consumers are not fully deregulated. This provides little economic incentive for electricity companies to enter the market. The reforms of the public electricity companies have substantially decreased their technical losses, improved their bill-collection rates, and strengthened their financial situations. However, shortcomings remain in the corporate governance and finances of the state-owned electricity companies. Competitive mechanisms have only been fully introduced for projects in renewable energy. In 2018, Albania successfully completed the first-ever renewable-energy support auction in the Energy Community, an organisation that aims to connect the EU's energy market with the energy market of some of the non-EU neighbours.

Functioning of the financial market

Financial stability

The declining stock of non-performing loans (NPLs) improved the stability of the banking system, but sovereign exposure and poor collateral-execution remain risks to stability. The ratio of NPLs to total loans fell to 11% by the end of 2018, down from 15.6% in 2017. NPLs declined mainly through write-offs, but Albanian banks resolved more NPLs through collateral execution in 2018 than they did in 2017. The banking sector also holds over 20% of its assets in government securities, exposing it to sovereign risks, while a quarter of domestic loans and deposits remain exposed to exchange-rate risks. Banking supervision and management have been increasingly aligned with international standards. The banking sector's capital adequacy and liquidity ratios remain well above the minimum regulatory levels. Return on equity softened from 15.7% in 2017 to 12.9% in 2018.

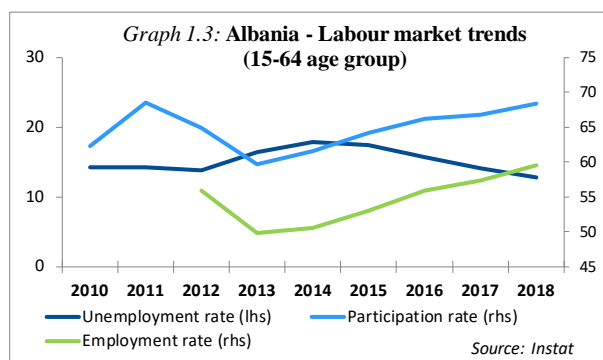
Access to finance

Financial intermediation remained undeveloped, and credit growth to the business sector stayed subdued. Credit to the private sector amounted to about 39% of banking sector assets in 2018. Credit growth to business was sluggish due to: (i) banks' greater risk awareness; (ii) tighter lending conditions; (iii) the low financial literacy of SMEs; and (iv) 'unbankable' business plans. Only lending to households picked up recently. The small but growing non-bank financial sector, with about 30 institutions, owned 10.7% of total financial sector assets in the first half of 2018. In February 2018, the first private stock exchange (ALSE - the Albanian Security Exchange) began trading government securities, but equity and corporate bond finance remain underdeveloped. Overall, financial inclusion remained low, with only 40% of adults and about 75% of SMEs holding bank accounts. The Bank of Albania has set out a plan to promote financial inclusion, which is important for reducing informality, illicit financial flows and remittance fees.

The functioning of the labour market

The economic upswing has translated into increasing employment and lower unemployment. Employment growth of 2.7% in 2017 allowed the unemployment rate to decline from 15.6% in 2016 to 14.1% in 2017 and to 12.8% in 2018. However, employment growth slowed further in 2017, falling to 2.1%. The high youth unemployment rate (covering the 15-29 age group) continued to fall, dropping from

33.2% in 2015 to 25.9% in 2017 and further to 23.1% in 2018. The working age population began decreasing in 2015, so the growth in labour supply has been driven by rising participation rates (which rose from 66.8% in 2017 to 68.3% in 2018). The gap between the labour force participation rates of men and women fell from 20.9 pps in 2014 to 17.2 pps in 2018. Public employment services improved job mediation, but active labour market policies remain limited in scope, insufficiently targeted and underfunded. Only a very limited number of the unemployed (2.2%) receive unemployment benefits or are in active employment promotion programmes. Thus, social benefits are not providing an incentive to withdraw from the labour market and the labour code provides sufficient flexibility not to dampen job creation. Overall, wages grew by about 3% in 2018 but overall Albanian salaries are among the lowest in the region and reflect the low productivity. Low incomes, low social security and low-quality job offers continued driving Albanians - in particular the higher educated (“brain drain”) - into emigration, although the recent employment growth decelerated this trend.



Three trends continue to transform the structure of the Albanian economy: the significant shift of employment to the non-agricultural private sector; the declining importance of agriculture; and the increasing service orientation of the economy. The share of employment in the non-agricultural private sector jumped from 34.1% in 2015 to 43.3% in 2018 (administrative data), but informal employment in this sector remained widespread with 30.3% of the workforce (LFS 2017). Meanwhile, the share of the labour force employed in agriculture and in the public sector continued to decline. In agriculture, the share of the labour force fell from 42.4% in 2015 to 39% in 2018, and in the public sector, it fell from 15.5% in 2015 to 14.5% in 2018. Still, agricultural employment is relatively high in absolute terms. Agriculture is often a form of self-employment for people with no other employment options, and the high levels of agricultural employment keep productivity low.

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

Albania has made **some progress** and has **some level of preparation** in its capacity to cope with competitive pressure and market forces within the EU. Energy, transport and digital infrastructure improved. However, Albania’s competitiveness is hindered by a lack of entrepreneurial and technological know-how and low education levels. This also hinders Albania’s integration into international value chains. Exports and regional integration are below potential. Efforts to improve education and training have led to some improvements, but reforms must continue to close the significant skills gap. Albania’s capacity for research, development and innovation remained low.

In order to improve competitiveness and long-term growth, Albania should in particular:

- increase spending on education and research in percentage of GDP and implementing the envisaged reforms to vocational education and training;
- improve the planning and execution of public investment;
- make better technical support services locally available for micro, small and medium-sized enterprises to help them to invest, innovate and to export.

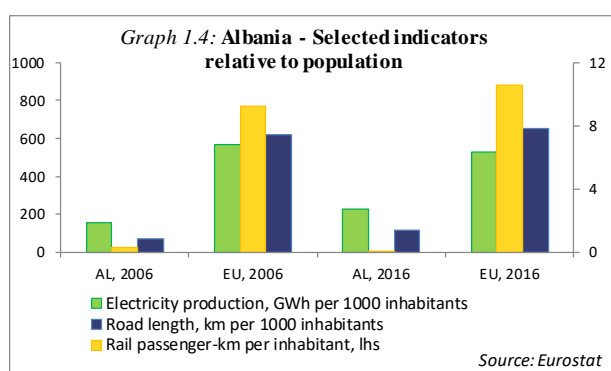
Education and innovation

Although education system outcomes have improved, they remained well below EU-average and are inadequately tuned to private sector needs. From a low base, Albania improved its scoring in the OECD's 2015 PISA assessment strongly but still about half of the tested students showed less than basic proficiency in three main competences. Almost half of the children enrolled in lower secondary education (85% enrolment) did not successfully complete it. Although VET enrolment as share of upper secondary education increased from 13% in 2013 to over 20% in the school year 2018-2019, only 11% of all youngsters between 15 and 19 years are attending vocational schools. Government's spending on education declined from 3.5% of GDP in 2013 to 2.4% of GDP in 2018, remaining below regional average and far below the appropriate level for a country with a large young population. As the Government's education policy does not systematically take into account private sector needs and often fails to enforce quality standards in vocational training institutions, young graduates often do not meet private sector expectations, with only 46.9% graduates being in employment in the year following graduation. The implementation of the action plan that requires the involvement of the public and private sectors together with universities is lagging behind.

The capacity for technological absorption, research, development and innovation remained low. Moreover, data on research spending is scarce; the few indicators available on research and innovation show a mixed picture: while the number of articles in scientific journals has declined, the number of patents and trademark registrations has increased, albeit from a very low level. The low research and technical extension capacity in the agricultural sector has not improved.

Physical capital and quality of infrastructure

Albania's annual public investment averaged 5.3% of GDP since 2013 and its infrastructure improved significantly, but the infrastructure gap to the regional and the EU average levels remains large. Investment has accounted for roughly one quarter of GDP in recent years. Overall investment grew by 4.6% in 2017, with about 40% invested in the electricity, gas and water sector.



Private investment (including large foreign investments) in energy and transport infrastructure has increased significantly in recent years. The IMF composite public infrastructure index of 2017 estimated the gap to the EU average infrastructure level at 70%. In particular, broadband internet coverage, highways and installed electricity generation capacity, though constantly increasing, were much below EU-levels and electricity outages remained frequent. The Albanian capital budget execution rate of 91% has been above

the average of its regional peers in 2017. In 2018, the capital budget execution could not keep up with the planned high growth of public investment and fell to 88% which still represents an annual capital expenditure growth of 12%. Public investment management still suffers from institutional-capacity constraints, overoptimistic planning and backloading. The large infrastructure investment needs and the increasing number of PPPs require: (i) more financing; (ii) clear frameworks for regulated prices (electricity, water, toll fees); and (iii) improved institutional capacity in the public sector for planning and supervision.

Sectoral and enterprise structure

The Albanian economy shifted further to the services sector, followed by agriculture and industry. Services further increased their share in GDP from 45.8% in 2014 to 48%, in 2018 led by trade and tourism related services and an increasing share of services in education and health. Agriculture as well as industry have lost some ground between 2014 and 2018 with shares decreasing from 23% to 18.4% and 14.8% to 12.2 respectively. The number of foreign enterprises in tourism, ICT and agriculture increased by almost 12% from 2016 to 2017.

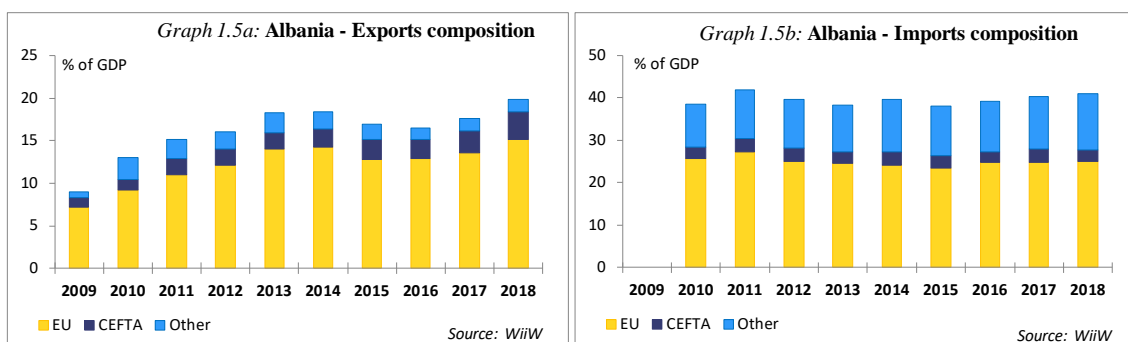
Most investment and employment depends on a very small number of enterprises. 89% of all enterprises in Albania had less than 5 employees in 2016 ('micro-enterprises') and only 5% of all enterprises had over 10 employees. The latter account for 75% of formal employment and 86% of investment in the economy. The slow change in this structure in recent years signals persistent obstacles for enterprise growth. Many micro-enterprises cannot access microfinance due to their lack of know-how or because they operate in the informal economy, whereas many SMEs (with more than 5 employees) are too large for microfinance institutions, but also face problems accessing bank financing. The low level of public support to SMEs and farmers poses a challenge for businesses aspiring to grow or to export.

Economic integration with the EU and price competitiveness

The EU remained Albania's main trading partner, but overall trade levels remained well below potential and undiversified. Albania's total global exports increased by 17% in value in 2018, exceptionally dominated in this year by electricity exports. Over the last years, commercial services led by tourism dominated exports, accounting for 58% of global exports. Goods exports - mainly manufactured textiles and footwear - continued to show little diversification in terms of products and destinations, while the potential for agricultural exports remained untapped. The EU accounted for 76.3% of Albania's goods exports and 61.1% of its goods imports in 2018, slightly less than in 2017. Italy remained the main destination for Albanian exports and a major source of remittances.

FDI inflows into Albania from the EU grew strongly over the last 2 years. FDI flows from the EU into Albania increased by 22% in 2016 and 44% in 2017. FDI from the EU accounted for 38.5% total FDI flows into Albania's in 2017. Nevertheless, the EU's share in Albanian FDI stocks declined from its peak of 66% in 2015 to 56% in 2017, partly due to a large build-up of FDI stocks in the energy sector by non-EU partners. Albania's integration into global value chains is mostly limited to manufacturing services in the textile and footwear apparel industries for Italian lead firms (known as 'cut, make and trim' services).

Albania's trade with Central European Free Trade Agreement (CEFTA) countries increased on account of a continuously increasing share of exports to CEFTA countries, mainly to Kosovo. Exports to CEFTA increased from about 11% of its total exports in 2013 to about 16% of total exports in 2018. Imports from CEFTA, in contrast, fell back to their 2016 level in 2018 at 6.7% of total Albanian imports while imports from other countries increased their share from 30.4% to 32.3%.



1.3. CONCLUSIONS

As regards the economic criteria, Albania has made some progress and is moderately prepared in developing a functioning market economy. Economic growth increased further and unemployment decreased but remains still high. Exports grew solidly and the current account deficit narrowed. The high public debt-to-GDP ratio continued to decrease but the pace of fiscal consolidation remained slow. Banks continued to reduce the number of non-performing loans and the use of foreign currency. The banking sector remained stable, though business credit growth did not pick up. Steps towards developing the financial market have been taken. The business environment has improved only in some aspects. Progress in the implementation of comprehensive justice reform is expected to contribute to strengthening the business environment and attracting investments. Some progress was made on increasing labour market participation and the quality and effectiveness of labour market institutions and services, but the employment rate and labour market participation remain low, and the informal economy is still a significant job provider.

Albania has made some progress and has some level of preparation in terms of capacity to cope with competitive pressure and market forces within the Union. Albania has made some progress in terms of energy, transport and digital infrastructure development, but lack of productive know-how, low education levels and technology transfers hinder Albania's competitiveness and integration into international value chains. Exports and regional integration are below potential. Efforts to improve education and training show some results but reforms need to continue in particular to better address rural areas and vulnerable groups. Albania's capacity for research, development and innovation remained very low.

2. 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.

Economic governance has become even more central in the enlargement process in recent years. The European Commission monitoring takes place in two processes: the Economic Reform Programme exercise and the below assessment of compliance with the economic criteria for accession. Each enlargement country prepares an Economic Reform Programme (ERP) annually, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

2.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro has made **some progress** and is **moderately prepared** in developing a functioning market economy. The economy continued expanding at a robust pace, improving labour market outcomes but the unemployment rate still remains high and the employment and activity rates very low. Despite positive export dynamics, the current account deficit remained very large, fuelled by strong domestic demand, and was only partially financed by net inflows of foreign direct investment. Financial sector solvency and liquidity ratios improved, but access to finance for small companies remains hampered by tight lending conditions. Fiscal consolidation efforts continued through 2018, but the budget deficit target was missed by a wide margin while public debt reached a new record, partly due to the financing needs for a large highway project financed by an international loan. Private sector development remained constrained by weaknesses in the business environment, an inefficient judiciary and a high prevalence of informality, reflecting poor implementation capacity in key state institutions responsible for enforcing the rule of law and competition.

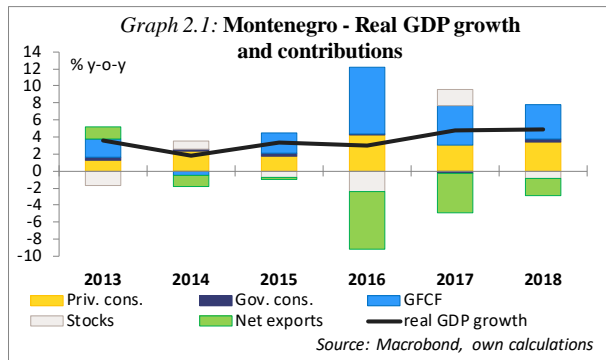
In order to improve the functioning of the market economy, Montenegro should in particular:

- strengthen debt sustainability by broadening the tax base and lowering the public sector wage bill as a percentage of GDP;
- provide public guidance on the implementation of laws that affect businesses and ensuring that the guidance is consistently followed by the public administration;
- develop a strategy to assess and reduce the informal economy and ensuring close cooperation between central and local authorities in fighting informality;
- strengthen employment activation measures and improving the coordination between employment and social services.

Economic governance

The implementation of economic and fiscal policy objectives has been delayed. The debt management and fiscal strategies, adopted as a response to rising public debt, are the cornerstones for strengthened economic governance. However, despite some positive results, such as reduced refinancing risks and higher budget revenues, the 2018 budget deficit turned out to be higher than the revised deficit target. This delayed –once again– the objective of reaching a balanced budget. Important reforms like those of the public administration, the labour law and the pension system were delayed. The reform of the tax administration advanced slowly, while the restructuring of the indebted national air carrier stalled. Delays in implementing large infrastructure projects reveal absorption capacity constraints. The policy guidance jointly adopted in May 2018 in the context of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey was implemented to a limited extent.

Macroeconomic stability



Driven by investment and consumption, the economy has expanded at a robust pace.

After recording real growth of 4.7 % in 2017, the economy continued to expand at a healthy pace. In the first three quarters of 2018, GDP grew by 4.8 % year-on-year (y-o-y). Public and private investment have been the main drivers of growth in recent years, also reflected in the strong performance by the construction sector. In spite of declining wages in real terms, household consumption was supported by bank lending, tourism

expenditure on local services and remittances. Government consumption contributed modestly to GDP growth due to fiscal consolidation measures. Export performance accelerated in the first three quarters of 2018, surging by 14 % y-o-y. However, due to the much larger volume of imports, net exports continued to be a drag on growth. Overall, solid growth over recent years helped raise Montenegro’s per-capita income in purchasing power standards to 46 % of the EU-28 average, following a period of stagnation at around 41 % over 2010-2015.

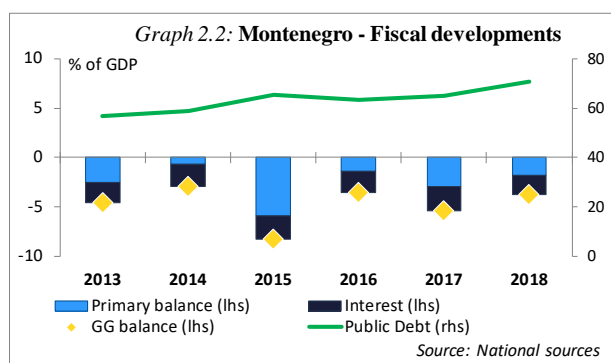
The sustained growth of domestic demand has continue to fuel a large current account deficit.

The completion of new hotels and power plants as well as the recovery of aluminium prices boosted exports in 2018 but was not sufficient to contain the expansion of the current account deficit. The current account widened to 17.2 % of GDP in 2018, compared to 16.1 % of GDP a year before. The merchandise trade deficit widened to 43.2 % of GDP as imports of goods outpaced the growth of exports. Rising exports of transport and tourism increased the services balance surplus to 20.3 % of GDP, or half percentage point higher compared to a year before. Net income and remittances from abroad brought about surpluses of 1.2 % and 5.7 % of GDP, respectively. Net inflows of foreign direct investment (FDI) only covered half of the current account deficit in 2018, contracting by 32.4 % over the year due to large outflows from the repayment of intercompany debt and the withdrawal of equity investment following the sale of a stake in the national electric company by its foreign owner.

Stronger demand and tax increases led to higher inflation.

Consumer prices have recorded continuous growth since the end of 2016, further accelerating at the beginning of 2018 due to the introduction of higher rates for value-added-tax (VAT) and excise duties. After peaking at 3.4 % y-o-y in June, the government withdrew the increase in excise on tobacco products in July, allegedly due to a rise in illegal trade and poor excise revenue collection. As a result, inflation started to slow in the second half of the year, settling at 2.8 % the average annual rate for the whole year, compared to a lower rate of 2.0 % in the period 2011-2015.

After several years of high fiscal deficits and growing public debt, the government took measures to rebalance the budget, but the deficit target for 2018 was missed by a wide margin. The fiscal reform package included, among others, an increase in 2018 of VAT rates and excise duties, as well as a new debt management strategy. In 2018, central government budget revenues increased substantially, boosted



by VAT receipts, income taxes and social security contributions. However, budget expenditure also kept increasing – albeit at a slower pace – driven by growing capital investment, gross salaries (in spite of planned downsizing), transfers to the public education and health sectors, and costs generated by unfavourable court case rulings against the public authorities. As a result, the general government cash deficit totalled 3.8 % of GDP at the end of 2018, exceeding the full-year deficit target of 2.2 % of GDP. The public

debt (including deposits) increased further to 70.8 % of GDP at the end of 2018, up from 64.2 % a year earlier. The main reasons for this increase were to finance the budget deficit and to increase government deposits to service future financial obligations.

Inherent limitations in macroeconomic policy compel a stronger commitment to fiscal consolidation. Montenegro's use of the euro as legal tender results in the practical absence of monetary policy, leaving fiscal and structural policies as the main macroeconomic toolkit. The strong economic performance and the need to reduce debt-related vulnerabilities called for a tighter fiscal stance in 2018 to strengthen macroeconomic resilience. Moreover, several important structural reforms were delayed.

	2010-15 average	2016	2017	2018
GDP per capita (% of EU-28 in PPS)	41,0	45,0	46,0	:
Real GDP growth	2,0	2,9	4,7	4,9
Economic activity rate of the population aged 15-64 (%) , total	59,8	63,4	63,5	64,8
<i>female</i>	48,3	56,6	56,5	57,2
<i>male</i>	66,3	70,2	70,5	72,3
Unemployment rate (%) , total	19,2	18,0	16,4	15,5
<i>female</i>	19,4	17,4	17,2	15,3
<i>male</i>	19,0	18,5	15,7	15,7
Employment (annual growth %)	0,5	1,1	2,1	3,2
Nominal wages (annual growth %)	2,1	3,5	2,0	0,1
Consumer price index (annual growth %)	1,9	0,1	2,8	2,9
Exchange rate against EUR	1,0	1,0	1,0	1,0
Current account balance (% of GDP)	-14,2	-16,2	-16,1	-17,2
Net foreign direct investment, FDI (% of GDP)	12,1	9,4	11,3	7,1
General government balance (% of GDP)	-5,1	-3,6	-5,3	-3,8
General government debt (% of GDP)	53,4	64,4	64,2	70,8

Source: Eurostat and national sources

Functioning of product markets

Business environment

The regulatory burden represents a major barrier for improving the business environment. In September 2017, the government adopted a law on administrative procedure and developed an internet portal (eRegulations.org) to increase the transparency of administrative procedures and facilitate business interaction with public services. Both market entry and exit procedures have been improved. Montenegro performs well at regional level in terms of the time and cost to resolve insolvency. In 2017, 90% of bankruptcy cases were solved within six months. However, other obstacles persist, like delays in the issuing of construction permits. Important legislative reforms, like the Law on spatial planning and construction of buildings, adopted in October 2017, are expected to improve the issuing of construction permits and the regulation of existing illegal constructions. However, implementation of the law is delayed by a number of factors, including the shortage of municipal architects to perform inspections, resulting in delays in processing some of the 50,000 requests to regularise informal constructions. Moreover, the cost of construction permits remains high and the time taken to issue the permits has increased since the new law came into force.

Businesses are resorting more often to out-of-court dispute resolution mechanisms. In the first half of 2018, over 500 cases were referred for mediation, an increase compared to 437 cases in 2017. The bailiffs system is a key pillar for enforcement of debt claims. However, the rate of resolved cases fell in the first half of 2018, with 24% of cases solved compared to 34% in 2017. The number of companies and entrepreneurs with frozen bank accounts due to unpaid claims continued to increase in 2018, totalling 17,940 at the end of the year (including some inactive or bankrupt companies). The rising trend points to persistent solvency problems in local companies.

The fight against the informal economy remains modest. Employers and investors associations often complain of unfair competition from other businesses' informal practices. The estimated size of the informal economy is 24.5% of GDP.⁽⁵⁾ However, state institutions responsible for enforcing the rule of law and competition are often side-lined or suffer from weak capacity. The Special Prosecutor's Office is investigating several cases of corruption involving money laundering, banks, politicians, civil servants and domestic and foreign companies. These cases are important to elucidate the independence and administrative capacity of the judiciary to protect the rule of law and fight against corruption. (*See Chapter 23 – Judiciary and fundamental rights*).

State influence on product markets

The government's direct interference in the economy remains limited. Administered prices account for 0.05 % of the harmonised index of consumer prices. The process of alignment with EU requirements is contributing to a gradual increase in market regulators' independence. Although local self-governments' payment arrears remain substantial (at 2 % of GDP at the end of 2018), these are mostly owed to the tax administration rather than to private creditors. Indebted municipalities are subject to a debt restructuring programme supervised by the Ministry of Finance. At 0.6 % of GDP in 2018, the budget allocation for State aid is relatively moderate. The national airline received a significant part of those subsidies, but still owes a significant amount of debt, including to the tax administration, putting the company at risk of bankruptcy. The government provides substantial tax exemptions to develop some sectors of the economy, including tourism, energy, construction and agriculture. However, it lacks an analysis of the impact of these tax exemptions to inform its policy decisions and of the compatibility of such exemptions with State aid rules. (*See also Chapter 8: Competition*).

⁽⁵⁾ IPSOS (2014), Informal Employment and the Grey Economy in Montenegro.

Privatisation and restructuring

Although the number of public companies is relatively low, the return to state-ownership of the energy utility EPCG represented a setback for the privatisation agenda. Private investors made use of a put option to sell back to the Montenegrin government their 41.7 % stake in EPCG, the largest company in the country. The government increased its stake to 70 % after paying a first instalment in May 2018, while the former strategic investor still holds some 18 %. In October 2018, BMJ Industries took over the majority (70 %) ownership in the New Tobacco Combine, restarting production more than two years after it was privatised. In 2018, a local investor acquired a 26 % stake from Serbia in the ‘Dr Simo Milosevic’ health institute, and applied together with a foreign partner for an additional 56 % stake owned by Montenegro. Concerns are mounting about the state-owned Montenegro Airlines and the railway operator (ZPCG) due to accumulating debt. The government is resorting more often to concession agreements to modernise and develop its assets, and is developing a new legal framework in this area to reinforce the principles of transparency, equal treatment and proportionality. In November 2018, the government granted a 30-year concession for the Bijela shipyard to a consortium formed by a local marina with an international shipyards group. Work is ongoing on the concession of the two international airports and a ski resort, as well as for public forests and agricultural land.

Functioning of the financial market

Financial stability

Although the situation of the financial sector keeps strengthening, small banks face large overhead costs and low profitability. Bank balance sheets have recovered significantly in the last six years. The non-performing loan ratio declined to 6.7 % in September 2018 from 17.6 % in 2012. The return on assets and on equity in the banking system stood at 1.5 % and 12.6 %, respectively (they were both in negative territory in 2012), while the overall capital adequacy ratio was 16.5 %, above the regulatory minimum of 10 %. However, large disparities still exist among credit institutions. Out of 15 banks operating in Montenegro, the four largest account for 95 % of total profits. The legal framework of financial supervision has been improved in 2017. There is a critical need to address vulnerabilities in the financial sector and effectively enforce financial supervision. On 4 January 2019, the Central Bank of Montenegro decided to start bankruptcy proceedings against Invest Bank Montenegro and to require that Atlas Banka recapitalise in order to continue operating. These banks account for 1.1 % and 5.8 % respectively of the banking sector’s total assets.

Access to finance

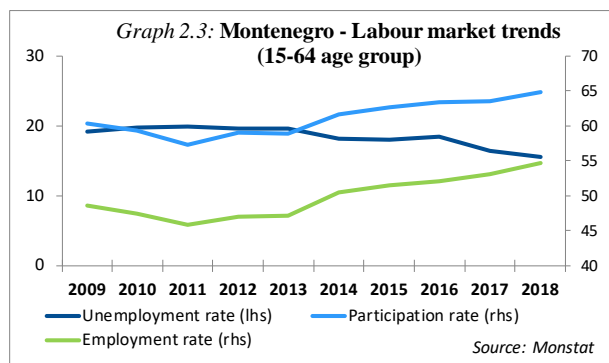
While household credit has been rising faster, bank lending to the corporate sector has regained pace since mid-2018. In the first eleven months of 2018, bank lending to the corporate sector grew by 8.2 % y-o-y. Lending to households kept growing even faster, at 10.9 %. This difference is partly explained by banks’ extremely high collateral requirements for corporate loans as these account for the bulk of impaired loans and are thus seen as riskier. To help with this situation, the state-run Investment and Development Fund (IDF) provides finance to SMEs at reduced interest rates via local banks.

The size of the non-bank financial sector remains very small. The stock market’s role in the local economy is marginal in terms of market turnover, while the assets of insurers and micro-financial institutions both represent around 1.5 % of GDP. In 2018, the lending capacity of the Investment and Development Fund accounted for almost 4 % of GDP, compared to an aggregated loan portfolio of commercial banks equivalent to 68 % of GDP.

Functioning of the labour market

Stronger economic growth supported better labour market outcomes. In 2018, the average employment and activity rates in the age group 15-64 increased to 54.7 % and 64.8 % respectively; up from 47.4 % and 58.7 % in 2013. The unemployment rate, according to the Labour Force Survey (LFS) data, fell to 15.5 % on average in 2018, down from 19.6 % in 2013. The average unemployment rate for women was slightly lower (15.3 %) compared to men's (15.7 %). However, women's participation rate (57.2 %) remains significantly lower than that of men (72.3 %). Youth unemployment (i.e. for the 15-24 age group) also declined to 29.4 % in 2018, from 31.7 % a year before. Long-term unemployment also declined. In 2018, the share of unemployed workers who had been looking for a job for more than 12 months was 75.1 %, down from 82.3 % in 2013. The Employment Agency registered similar trends but with higher unemployment rates (i.e. 17.8 % in December 2018). This data discrepancy reflects the high proportion of informality, estimated to affect between 25 % and 33 % of employment.

Labour costs contribute to reduced work incentives and low transitions from informal to formal work. The tax wedge (at around 40 %) is relatively high, especially for low-wage earners. This may generate disincentives to hire and work, particularly at the lower end of income distribution. In addition, this is coupled with weak employment activation measures and its insufficient coordination with social assistance and opportunities to engage in undeclared work. This further contributes to unemployment and inactivity. The upcoming labour law reform is also expected to improve labour market flexibility and ease transfer to formal employment, but its adoption is still pending. Local companies hire foreign workers for seasonal jobs, but partly also to address the issue of low mobility of local workers. In 2018, more than 20,000 work permits were issued to foreign workers.



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

Montenegro has made **some progress** and remains **moderately prepared** in terms of its capacity to cope with competitive pressure and market forces within the EU. The development of infrastructure in a number of areas is gradually setting the preconditions for improved economic competitiveness. However, further efforts are needed to enhance human capital development and to reduce the mismatch between education outcomes and labour market needs. Local companies need to grow and step up efforts to increase international competitiveness.

In order to improve competitiveness and long-term growth, Montenegro should in particular:

- increase the provision of upskilling and reskilling measures;
- develop access to broadband networks and facilitate business use of the information and communication technologies.

Education and innovation

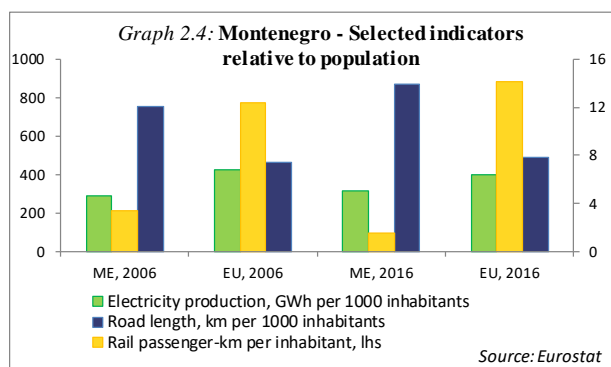
Efforts have been made to further strengthen the national education system. In test scores of the OECD's 2015 Programme for International Student Assessment (PISA), Montenegrin students underperformed in science and mathematics by an equivalent of 2.5 years against the OECD average, but

improved notably in reading (by 19 score points since 2009). The new higher education structure (3+2+3 years) is being strengthened with the reform of university study programmes, and by the implementation of on-the-job learning, now applied to 25% of study programmes (*See Chapter 26: Education and Culture*). However, there is a persistent mismatch between education outcomes and labour market needs. Modernisation of secondary vocational education further advanced in its second year of implementation, with both the number of participating students and employers increasing. However, the effects of the introduction of practical learning in higher and vocational education are yet to be established through comprehensive monitoring.

Investment in research and development (R&D) is growing. Investment in R&D amounted to 0.32% of GDP in 2016 (or some 7% of total government spending), still below the target of 0.6% of GDP set for 2020. Montenegro has been gradually improving its participation in numerous international programmes and cooperation projects. National programmes increased funding by resorting to business co-financing. In 2018, the voucher scheme for innovation was extended to all SMEs. However, the application process remains complex and few companies applied. The groundwork is being laid for stronger links between business and the academic community. In addition to the work on the institutional and legal frameworks, progress has continued on two practical initiatives in this area. Firstly, the new centre of excellence for research in Nikšić, the first in a network of four institutions and part of Montenegro's science and technological park, is operating as a business incubator promoting entrepreneurial and innovative culture. Secondly, work is continuing on the innovation and the science and technological park in Podgorica that will implement the smart specialisation strategy to prioritise which areas of investment could generate the strongest growth.

Physical capital and quality of infrastructure

Montenegro keeps improving its transport, energy and environmental infrastructures. Reconstruction and modernisation of the road network has been advancing. However, the construction of the priority section of the Bar-Boljare highway suffered delays and cost overruns, further affecting the country's already narrow fiscal space. Decisions on the construction of the next sections must be based on a careful analysis of the financing scheme and in full compliance with applicable EU standards on public procurement, State aid and environmental impact assessment. Meanwhile, preliminary studies are underway for building the Adriatic-Ionian highway, which would set a second highway parallel to the coast. Several railway track sections and signalling are being upgraded. The draft concession agreement



for upgrading the two main airports is well advanced. New energy supply capacities progressed with the launch of a 50-megawatt windmill farm at Mozura and the issuing of several licences to build and operate solar power plants, including a large 250 MW solar plant at Briska Gora. The construction of the electricity transmission corridor towards Italy progressed as planned. Development of environmental infrastructure continues with a number of water distribution and treatment systems and waste management plants under

construction.

Implementation of the strategy for developing the information society is delayed. Legislative and infrastructure hurdles hamper attainment of the targets for broadband access (i.e. basic broadband access to all the population in 2018, and high speed broadband access of 30 Mbit/s or more in 2020). The low population density and difficult topography increases the costs of broadband deployment, discouraging

investments in the less-populated areas. In 2018, 72.2% of households and 99.2% of enterprises (with 10 employees or more) had access to the internet. Moreover, 80% of companies with internet access have a website. However, in 2018, only 8% of SMEs sold online, compared to the EU average of 17%. Overall, the development of IT skills and increased business use of ICT could boost Montenegrin companies' competitiveness and facilitate their access to foreign markets. Online access to real-time cadastral services is in place.

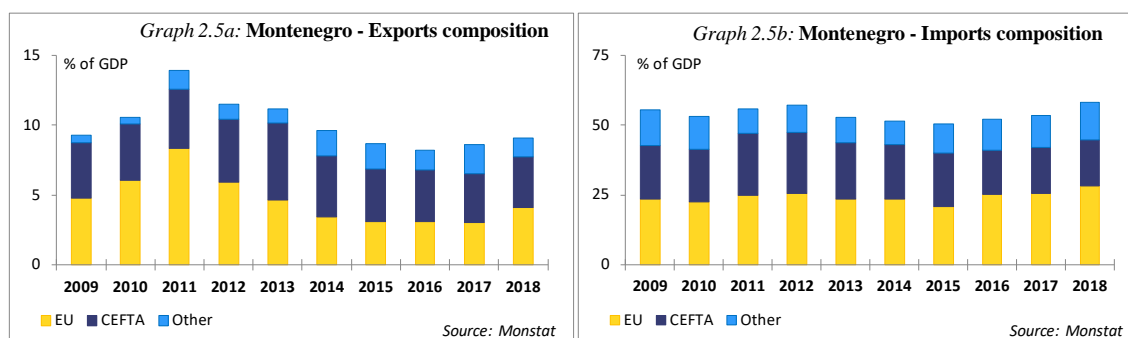
Sectoral and enterprise structure

Services, and tourism and sales in particular, remain the mainstay of the economy, despite some modest rebalancing towards agriculture and manufacturing. In 2017, services provided 71.8% of total gross value added (GVA) and 75% of total employment, down from a 74.5% contribution five years earlier. Agriculture and manufacturing account for 7.9% and 17.1% of employment, but their contribution to gross value added is more in favour of the former (10.9%) than the latter (11.9%). Construction's share in total GVA has remained relatively stable, at around 5.4% in 2017, accounting for 7.6% of employment.

Local firms suffer from low levels of competitiveness. SMEs are the backbone of Montenegro's economy, generating almost 70% of value added and more than three quarters of employment. However, SMEs face numerous challenges. Firms identify access to finance as one of the biggest obstacles to doing business. Other challenges include red tape, inadequate infrastructure and an insufficiently skilled workforce. Several support mechanisms to increase the competitiveness of local SMEs have been developed. These include programmes for cluster development, and a strategy to improve SME innovation and competitiveness. The Investment and Development Fund is also offering new credit lines for competitiveness. However, complex procedures when applying for small grants discourage applicants.

Economic integration with the EU and price competitiveness

Trade integration with the EU has strengthened gradually. In 2018, trade with the EU accounted for 44.9% of Montenegro's goods exports and 48.3% of its goods imports, showing some increase compared to five years earlier (41.0% and 44.0% in 2013). During the same period in 2018, trade with CEFTA parties accounted for 40.2% of Montenegrin exports and 28.5% of its imports, a significant decline compared to the 2013 levels of 49% and 39%, respectively. The Regional Economic Area framework, to which all Western Balkan economies have committed, offers an opportunity for increasing trade exchanges. However, regional non-tariff barriers, in particular the time taken and procedures needed for border crossing, still appear to hamper stronger intra-regional trade. Financial integration with the EU remains substantial, as the EU accounted for 85.8% of capital in local banks and 45.6% of total FDI inflows during the first nine months of 2018.



Montenegro's trade exchanges remain heavily tilted towards imports. Imports of goods and services totalled 64.5% of GDP in 2017, or 1.5 times higher than the value of its exports. This situation reflects several shortcomings, including the fact that only 7% of firms export their goods, and that only one out of

three export flows that start in a given year will survive past the first year. The manufacturing base remains concentrated on commodities with low value-added and with a high dependence on imported intermediate goods. Trade openness has slightly declined over time, from 106.7% of GDP in 2011, to 105.6% in 2017.

2.3. CONCLUSIONS

As regards the **economic criteria**, Montenegro has made some progress and is moderately prepared in developing a functioning market economy. The economy continued expanding at a robust pace, improving labour market outcomes even though the unemployment rate remained high. Despite positive export dynamics, the current account deficit, fuelled by strong domestic demand, remained very large and was only partially financed by net inflows of foreign direct investment. Financial sector solvency and liquidity ratios improved, but access to finance for small companies remains hampered by tight lending conditions. Fiscal consolidation efforts continued through 2018, but the budget deficit target was missed while public debt reached a new record, partly due to financing needs for a large highway project, financed by a Chinese loan. Private sector development remained constrained by weaknesses in the business environment, the judiciary, and a high prevalence of informality, reflecting poor implementation capacity in key state institutions responsible to enforce the rule of law and market competition.

Montenegro has made some progress and is moderately prepared in its capacity to cope with competitive pressures and market forces within the Union. The development of infrastructure in a number of areas is gradually setting the preconditions for improved economic competitiveness. However, further efforts are needed to enhance human capital development and to reduce the mismatch between education outcomes and labour market needs. Local companies need to grow and step up efforts to increase international competitiveness.

3. NORTH 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.

Economic governance has become even more central in the enlargement process in recent years. The Commission's monitoring takes place in two processes: the Economic Reform Programme exercise and the below assessment of compliance with the economic criteria for accession. Each enlargement country prepares an annual Economic Reform Programme (ERP), which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

North Macedonia has made **some progress** over the last 12 months and is at a **good level of preparation** in developing a functioning market economy. Economic growth resumed after a year of stagnation, though investment remained subdued. The government took measures to improve public finance management and transparency. It adopted reforms of income taxation and the pensions system. However, the composition of spending worsened, and fiscal consolidation needs to be more ambitious in order to put public finances on a sustainable path. The functioning of the labour market is impaired by persisting structural problems.

In order to improve the functioning of the market economy, North Macedonia should in particular:

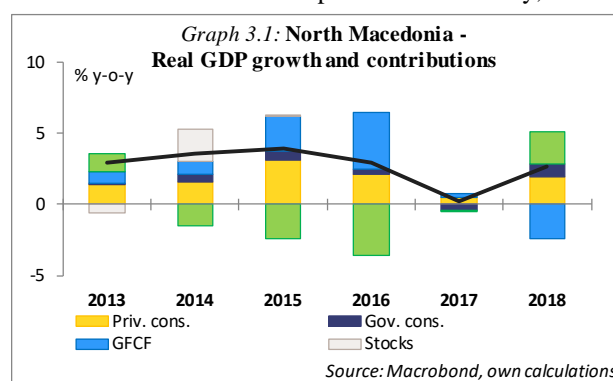
- stabilise the debt ratio by moving towards a balanced primary budget and by improving revenue collection;
- improve fiscal governance by adopting fiscal rules and a proper medium-term expenditure framework;
- implement measures to reduce the informal economy in accordance with the 2018-2020 strategy and action plan;
- implement the youth guarantee in the whole territory of the country with an emphasis on underdeveloped regions.

Economic governance

The government pursues market-based economic policies, with an increased focus on social cohesion, while also enhancing state aid. In collaboration with the IMF, the World Bank and the European Commission, the government implemented reforms to improve public finance management, and to introduce progressive income taxation. It adopted changes to the pensions system, which are expected to lead to lower pension expenditure and higher government revenue in the medium term. The government continued to implement the 2017 public administration reform strategy. It took steps to ensure the independence of the judiciary, and to fight corruption. Financial support for business investment and employment was increased, while criteria for and beneficiaries of state aid remained opaque. Minimum wages were raised, while productivity growth is subdued and the informal economy remains sizeable. The policy guidance jointly agreed at the May 2018 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented.

Macroeconomic stability

Economic growth picked up in 2018, but investment remained muted. After stagnating in 2017 as confidence suffered due to political uncertainty, GDP growth accelerated to 2.7% y-o-y.⁽⁶⁾ Consumer



spending was boosted by rising wages, transfers, and household credit. Investment, however, which had been increasing at an average annual rate of 5% between 2012 and 2016, did not recover from the trough it entered in 2017. Manufacturing output continued to expand, though at a slower pace than the average of the preceding 5 years. Convergence with EU income levels remains sluggish. Real GDP per capita has increased from 34% of the EU-28 average in 2012 to 37% in 2017.

	2010-15 average	2016	2017	2018
GDP per capita (% of EU-28 in PPS)	35,0	37,0	37,0	:
Real GDP growth	2,6	2,9	0,2	2,7
Economic activity rate of the population aged 15-64 (%) , total	62,0	64,5	65,3	65,4
<i>female</i>	48,7	50,8	51,7	52,2
<i>male</i>	76,8	77,8	78,4	78,3
Unemployment rate (%) , total	30,0	24,0	22,5	21,0
<i>female</i>	24,4	22,9	22,0	20,1
<i>male</i>	27,3	24,6	22,9	21,5
Employment (annual growth %)	1,9	2,4	2,7	2,5
Nominal wages (annual growth %)	1,2	2,0	2,6	5,7
Consumer price index (annual growth %)	1,8	-0,2	1,4	1,5
Exchange rate against EUR	:	61,60	61,57	61,51
Current account balance (% of GDP)	-2,0	-2,9	-1,0	-0,3
Net foreign direct investment, FDI (% of GDP)	2,6	3,3	1,8	5,8
General government balance (% of GDP)	-3,4	-2,7	-2,7	-1,8
General government debt (% of GDP)	32,7	39,6	39,3	40,5

Source: Eurostat and national sources

Notes: *four quarters or fourth quarter (Q4) or estimates (f), depending on the data availability

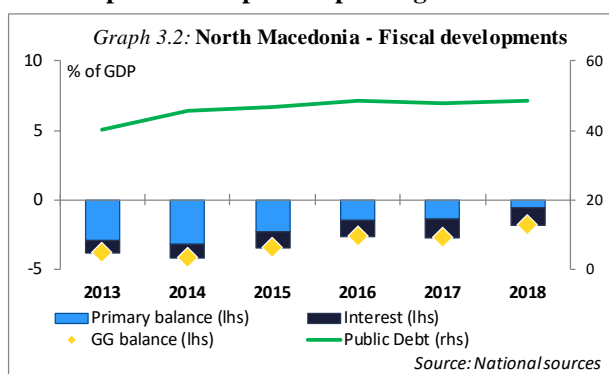
External vulnerabilities remain contained. The current account deficit narrowed by 0.7 percentage points (pps) year on year (y-o-y) in 2018, to 0.3% of estimated GDP, driven by further improvement in the trade balance. Private transfers remained stable compared to 2017, but still below their average of the past 5 years, by over 1pp. Inflows from foreign direct investment also increased markedly in 2018 after a slump in 2017 and stood at 5.8% of GDP, well above their average of 2.6% in the preceding 5 years. External debt has, however, been rising rapidly since 2009 on the back of heavy public sector borrowing abroad and rising intercompany debt. At 74% of GDP at the end of 2018, it is higher by 4pps than the average in 2013-2017. Moreover, the high degree of euroisation of banks' loans and deposits poses a further challenge on the external side. Foreign exchange reserves were replenished in 2018 after having dropped in the previous year, which more than compensated for the government's early partial repayment

⁽⁶⁾ According to a first estimate from the national statistical office.

of a Eurobond due in 2020. At the end of 2018, reserves stood some 23% higher than 1 year earlier and covered some 4-5 months of prospective imports.

The monetary policy stance remains supportive of price stability and the currency peg. In 2018, consumer prices increased by 1.5% on average, only slightly faster than in the previous year (1.4%). Inflation was driven by rising energy prices and related spill overs, in particular to the transport sector. Core inflation remained muted. Stable foreign exchange markets and solid economic fundamentals prompted the central bank between March 2018 and March 2019 to lower the key interest rate in four consecutive steps of 25 basis points (bps) each to a historic low of 2.25%. The central bank continued to pursue the ‘denarisation’ of banks’ balance sheets, with moderate success. The share of foreign currency-denominated loans to total loans dropped further, to 41.4% at the end of 2018 (-1.1pps y-o-y), but remains high. Overall, the current monetary policy stance is considered to be in line with economic fundamentals, given, in particular, still moderate inflation dynamics, low risks to external stability and a fairly mild pick-up in corporate lending.

The composition of public spending has worsened. Government expenditure has been increasingly



tilted towards current expenditure over the last 6 years. Social transfers made up half of total expenditure in 2018, only a slight decline from the preceding year. The proportion of capital expenditure, after having risen between 2009 and 2012, has declined since, from 12% in 2012 to 6% in 2018. Overall, the improvement in primary fiscal deficits between 2015 and 2018 mainly resulted from under-implementation of capital expenditure (however, this does not account for capital expenditure carried out by off-budget

entities). Including the public enterprise for state roads (PESR), primary deficits amounted on average to around 2.4% of GDP between 2008 and 2017. Smaller deficits are needed to ensure the stabilisation of public debt in the medium- to long run. The government has taken some measures to raise revenue and tackle the pensions deficit. The 2019 budget incorporates higher pension contribution rates, and a change of pension indexation to inflation-only, as well as a return to progressive income taxation, and an increase in capital gains tax. Yet, increased state aid and social transfers have added risks to fiscal consolidation.

Fiscal deficits drive public debt levels. Public debt, in terms of GDP, dropped slightly in 2017 for the first time since 2009 and increased again only marginally in 2018, to 48.4% at the end of the year. The government financed a large part of the fiscal deficit and debt redemption from its deposits at the central bank and from foreign reserve accumulation. Vulnerabilities arise from the high share of foreign-currency denominated debt (about 80%), which increased in the last years, and a large share of short-term maturities. With the growing reliance on Eurobonds, the floating rate-share of debt (about 35%) has been decreasing in recent years.

The management of public finances improved further. The government continued the clearance of unpaid public sector liabilities and previously blocked VAT refunds, and set up accounting tools to prevent the build-up of future arrears. The implementation of the Public Financial Management Reform Programme, which was adopted in December 2017, is on track for the most part. However, the new organic budget law, which sets out fiscal rules, a medium-term budget framework, and the establishment of an independent fiscal council has not yet been adopted. Moreover, the borrowing of public enterprises tasked with major public infrastructure works increasingly drives public debt and contingent liabilities for

the government. The financing of these off-budget entities remains opaque, and is generally not included in general government fiscal reporting even where required by statistical standards.

The policy stance needs further adjustment to address economic and fiscal challenges. The current policy mix of expansive fiscal policy and accommodating monetary policy is still largely appropriate given the moderate rebound of economic activity amidst contained inflation. The government's reforms to reduce the pension deficit and return to progressive income taxation are likely to improve public finances in the medium-term. However, fiscal space has narrowed in past years and the recent stepping-up of income support and state aid carries new risks to fiscal sustainability. In addition, the increase in minimum wages poses a challenge for competitiveness given stagnating labour productivity and shortcomings in workers' skills. Addressing these issues requires: (i) a well-calibrated interaction between more ambitious fiscal consolidation through lower primary deficits and preservation of growth-enhancing capital expenditure; (ii) further structural reforms to make labour and product markets more competitive; and (iii) progress in the rule of law and the fight against corruption.

Functioning of product markets

Business environment

Contract enforcement is still inefficient. Institutional capacity to enforce the law remains weak, and resolving a commercial dispute through a court is time-consuming and costly. Some optimism for business comes from the government's commitment to reduce the number of unannounced inspections and the amount of para-fiscal fees. The legislation on inspections is currently being amended with a view to also reducing the fines for various misdemeanours. It is important to ensure that the new legislation introducing transparent inspections procedures carried out by inspectorates with clear mandates is applied. The delays in VAT returns and public bodies' compliance with their payment obligations to the private sector as required by the EU Late Payment Directive continue to impact negatively on companies' liquidity. Legislative reforms are under way to improve the independence and impartiality of the courts. Amendments to relevant laws concerning disciplinary liability of judges and procedures have been adopted. In 2018, the number of new companies decreased by 5% compared with the previous year. No further measures were taken in the reporting period to simplify company registration. Deletions on the company register decreased by 39% and new bankruptcy procedures by 48%. The new bankruptcy law is still under preparation.

Competition from the informal economy weighs on the competitiveness of the formal private sector. The size of the informal economy, estimated by the national statistical office at about 17.4% of total output in 2016, has decreased only slowly over the past years, in spite of previous measures. In 2018, the government adopted a strategy and action plan to reduce informal employment, outlining a number of measures for the formalisation of jobs and targeting shortcomings in the business environment considered likely to drive firms to informality. Companies define the large shadow economy and the entrenched corruption as major obstacles to doing business and as negatively affecting investment behaviour.

State influence on the product market

Private ownership is dominant, but the transparency of state aid is still an issue. At the end of October 2018, the number of companies in which the government held a stake remained the same as in the three preceding years (16 companies in full state ownership). The value of state assets as a percentage of GDP remained at the level of previous years (11.4%). However, the governance of state-owned enterprises (SOE) falls behind on international good practice on some counts. Companies continue to be subject to para-fiscal charges with no clear purpose, in particular at local level. In addition, the large share of state-owned land remains an obstacle to agricultural development, restricting its use as collateral. Transparency on selection procedures and beneficiaries of state aid, which was enhanced through the government's 'Plan for Economic Growth' is still an issue. There is no single state aid registry, which

undermines the capacity of the Commission for Protection of Competition (CPC) to disclose, monitor or evaluate the effectiveness of state aid. The regime's compatibility with EU rules is also questionable.

Privatisation and Restructuring

There were no further privatisations of state-owned companies in the reporting period. The government ruled out the privatisation of electricity producer 'ELEM'. The company is putting in place ownership unbundling, in line with the Third EU Energy Package. The restructuring of the privatised tobacco company 'Tutunski kombinat AD Prilep', one of the companies with the biggest government share, which entered into a strategic partnership with Philip Morris in 2014, is proceeding slowly. The government is still in the preparatory stages of privatising the composite material producer 'Eurokompozit AD Prilep'.

Functioning of the financial market

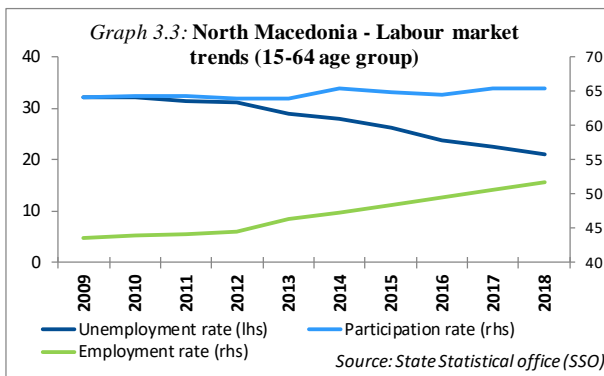
Financial stability

The banking sector further improved its resilience. Banks dominate the country's financial sector, even though their share in total financial sector assets fell to 83% in 2017, down from 88% in 2013. Concentration remains high and unchanged compared with previous years, with some 58% of assets held by the three biggest banks (out of 15). Liquidity is abundant — liquid assets account for one third of total assets and cover more than half of short-term liabilities. The capital adequacy ratio rose further in 2018, well exceeding the regulatory minimum. The share of non-performing loans (NPL) in total loans to the non-financial sector (including mandatory write-offs) dropped by 1.1pps y-o-y to 5.2% at the end of 2018. The decline is mainly due to the collection of non-performing claims in the corporate sector. However, a proportion of NPL was shifted off banks' balance sheet, impeding loan restructuring. The share of euro-denominated deposits and loans remains high, in spite of a number of measures by the central bank to incentivise lending and saving in local currency.

Access to finance

The level of financial intermediation deepened further. Financial sector assets rose further during the reporting period, to 76.2% of GDP (+1.3pps y-o-y) at the end of 2018. Private, non-financial sector loans rose by an average of 6.2% on the previous year. Households accounted for most of the credit increase, while growth of corporate credit, which has been picking up continuously since autumn 2017, also accelerated. However, strict collateral requirements and complex application procedures remain a problem for loan seekers. Commercial bank loans remain by far the main source of financing for small and medium-sized businesses.

Functioning of the labour market



Declining unemployment conceals structural problems. Supported by government programmes, job creation continued at a solid, though decreasing pace (2.4% on average between 2012 and 2018). Amidst a declining labour force, the average annual unemployment rate (15-64 age group) dropped by almost 10 pps to 21% between 2012 and 2018. However, structural problems in the labour market impair the economy’s potential to raise productivity. The decrease in overall unemployment partly reflects low

activity rates. The gender gap remains significant, with about 78% of men participating in the labour market, compared with 52% of women, with little change over the past 5 years. Youth unemployment, which has slowly, but steadily declined in recent years, remains high. The employment rate has increased from 44% in 2012 to 51.7% in 2018, but remains low by regional comparison. Around 80% of unemployed are long-term unemployed, reflecting the skills mismatch. In the last 5 years the labour force declined by almost 1%, mainly because of high emigration.

Informal employment continues to decline, but the proportion remains high. The proportion of informal employment, at 18.1% in 2017, has decreased steadily from 28.6% in 2008, but remains significant, especially for the low-skilled. The high labour tax wedge affects participation and formal employment. In August 2018, the government adopted an action plan to implement its 2018-2020 strategy for incentivising the formalisation of informal work, flanked by improvements to the administration’s monitoring capacity. The government has also taken measures to curb cash and ‘envelope’ payments.

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

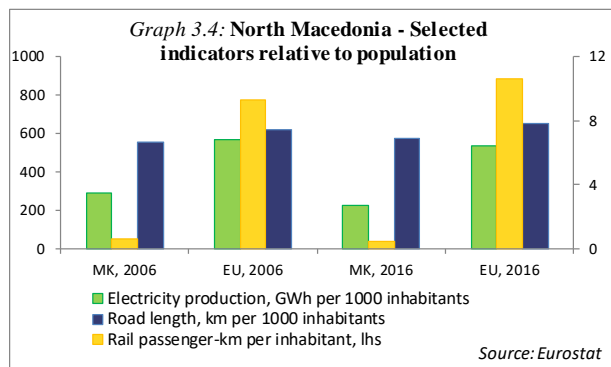
North Macedonia has made **some progress** and is **moderately prepared** to cope with competitive pressures and market forces within the EU. Integration with the EU in trade and investment deepened further. Exports and manufacturing output diversified further towards higher-value products. However, skills shortages, and a lack of skills alignment with those required by companies, reflecting shortcomings in education curricula, as well as infrastructure investment gaps impair labour productivity and the competitiveness of the economy.

In order to improve competitiveness and long-term growth, North Macedonia should in particular:

- complete investment in road and rail transport;
- strengthen governance and efficiency of spending in the education sector in order to accelerate the modernisation of the education system at all level;
- address the causes for weak integration of domestic companies in global value chains.

Education and innovation

The skills mismatch is obstructing competitiveness and growth. Public expenditure on education — around 4% of GDP on average over the last 5 years — is only somewhat lower than the EU average.



However, enrolment and completion rates in secondary (about 87% completion) and post-secondary education remain below the EU average and have risen only marginally in this period. Education outcomes are below most regional peers, and lower than could be expected from the country's income level, as shown in the latest (2015) PISA ranking and the 2018 World Bank's Human Capital Index. The gap between skills offered by graduates and those sought by companies, restrains potential growth and is exacerbated by the

large-scale emigration of high-skilled labour. The government has piloted reformed vocational curricula, including grants for cooperation between companies and schools. In spring 2018, it adopted a new

education strategy, but implementation is largely outstanding. Reform of quality assurance and standardisation in primary and secondary education is also still on the agenda. The lack of qualified workers further complicates the cooperation between established foreign and domestic companies, impeding the structural transformation of the economy.

Public and private spending on research and development (R&D) remains low. At 0.4% of GDP in 2017, the economy's expenditure on research and innovation has not increased over recent years, and remains significantly below the EU average (2% in 2016). The business sector accounts for only around 26% of overall R&D expenditure. The government supports private R&D through the Innovation Fund, which started disbursements in 2015, but had a slow take-up. In 2018, funds were bolstered and the regulatory framework was amended resulting in an increase in disbursements.

Physical capital and quality of infrastructure

Investment gaps hamper productivity growth. The quality of the capital stock is generally low, even though foreign direct investment has upgraded production plants in some sectors in recent years. The widely outdated transport, energy, health and education infrastructure negatively affects labour productivity. The investment gap is particularly big in the energy sector. Low capacity for power production leads to frequent power-cuts and losses in power transmission and distribution. The establishment of a cross-border power exchange is hampered by price regulation in the national electricity market. The construction of an electricity line with Albania is at an early stage, and a planned gas interconnection with Greece is still at the funding stage.

Cross-border connectivity in transport is advancing. The last part of the 'Corridor X' motorway was completed in 2018 and road works on 'Corridor VIII', which had been stalled temporarily on the section Kicevo-Ohrid, have resumed. However, the upgrading of rail connections to neighbouring countries and the facilitation of cross-border crossings is slow. Cumbersome procurement procedures and contractors' poor performance hamper implementation. Given these shortcomings, investment spending remains insufficient — in 2018, gross capital formation amounted to 33% of GDP, unchanged from one year earlier. The digitalisation of the economy is progressing, but remains low compared with the EU. The percentage of households with internet access at home has increased by 21pps between 2012 and Q1 2018 (79.3%) and mobile broadband penetration is expanding further. However, fixed broadband penetration is

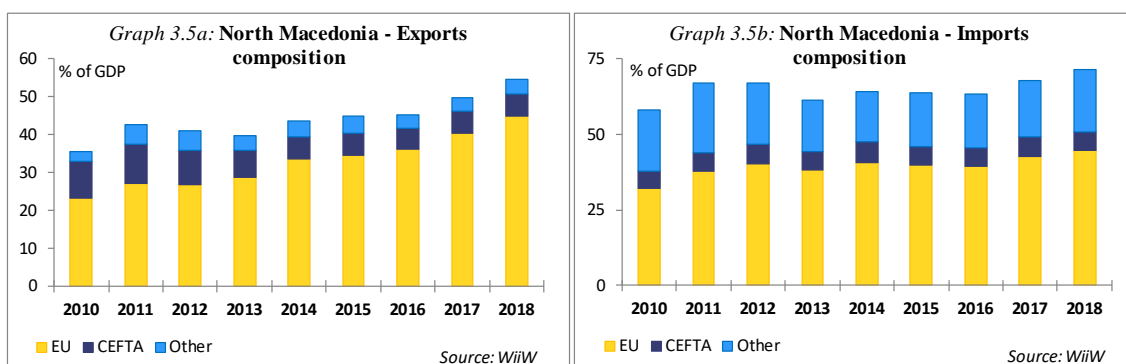
still restricted, which negatively affects business competitiveness. Online sales are also developing sluggishly.

Sectoral and enterprise structures

The structural transformation of the Macedonian economy remains slow. The sectoral and business structure of the economy has remained largely unchanged in the past 5 years. At some 60%, services account for the largest proportion of gross value added. Industry contributed 19.5%, which is only slightly above its share in 2013, and agriculture accounted for 10%. Mainly due to foreign companies, industry’s share of higher value-added manufactured goods (machinery and equipment, chemical products) rose at the expense of basic goods (iron, steel and clothing). Over half of the economy’s jobs are provided by services, which is only slightly more than 5 years earlier, followed by industry (31%, compared with 30% in 2013) and agriculture (16%, down from 19% in 2013). Over 99% of all companies are SMEs, providing over 77% of value added in the economy and an almost equal amount of employment. 40% of companies were active in the trade sector, and 13% in manufacturing. The government is supporting SMEs through the Competitiveness, Innovation and Entrepreneurship Programme, and the Economic Growth Plan. In 2018, the government adopted a new SME strategy for 2018-2023. In February 2018, it adopted a medium-term programme for financial support of micro and SMEs through co-financed grants from the Innovation Fund.

Economic integration with the EU and price competitiveness

The importance of the EU as a trade and investment partner continues to grow. The economy posts a high and growing degree of trade openness, at 126% of GDP in 2018 (+8pps y-o-y). Exports to the EU, which accounted for 82% of total exports, increased by 18.4% y-o-y, and imports from the EU were higher by 11.5%. While trade volumes with other Western Balkan countries continued to increase in 2018, the share in total trade declined further (-0.7pps to 11% of total exports, and -0.8pps to 8.8% of imports). EU firms also increased their share in the country’s stock of foreign investment in the past years, accounting for some 82% of total in 2017 (+3pps y-o-y). The economy’s structural transformation remains driven by foreign investors. However, integration in global production networks remains scarce, mainly due to the type of products manufactured by the FDIs, and the position of FDIs in the structure of global value chains (i.e. upstream or downstream). The international cost competitiveness of



the economy deteriorated somewhat further in 2018, as the increase in gross wages (on average +5.7 % y-o-y), reinforced by the rise in minimum wage levels decided by the government, outpaced labour productivity growth. The real effective exchange rate (CPI-based) has remained stable in the past 5 years.

3.3. CONCLUSIONS

As regards the economic criteria, North Macedonia has made some progress and is at a good level of preparation in developing a functioning market economy. Economic growth resumed after a year of stagnation, though investment remained subdued. The government took measures to improve public finance management and transparency. It adopted reforms of income taxation and the pensions system. However, the composition of spending worsened, and fiscal consolidation needs to be more ambitious in order to put public finances on a sustainable path. The functioning of the labour market is impaired by persisting structural problems. Contract enforcement and large informal economy continue posing challenges for the business environment.

North Macedonia has made some progress and is moderately prepared to cope with competitive pressures and market forces within the EU. Integration with the EU in trade and investment deepened further. Exports and manufacturing output diversified further towards higher-value products. However, skills shortages, and a lack of skills alignment with those required by companies, reflecting shortcomings in education curricula, impair labour productivity and the competitiveness of the economy. Important investment gaps in public infrastructure remain.

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.

Economic governance has become even more central in the enlargement process in recent years. The Commission's monitoring takes place in two processes: the Economic Reform Programme exercise and the below assessment of compliance with the economic criteria for accession. Each enlargement country prepares an Economic Reform Programme (ERP) annually, setting out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia has made **some progress** and is **moderately prepared** in developing a functioning market economy. External imbalances are on the rise, although their financing remained healthy. Price pressures remained subdued and inflation expectations contained. Major fiscal adjustment over previous years has significantly improved debt sustainability. Financial sector stability was preserved and labour market performance has improved with the exception of the activity rates of women and young people, which declined.

However, major structural reforms of public administration, the tax authority, and state-owned enterprises (SOEs) advanced slowly, prolonging long-standing inefficiencies. The authorities are only slowly addressing weaknesses in the budgetary framework and its governance. The state retains a strong footprint in the economy and the private sector is underdeveloped and hampered by weaknesses in the rule of law, in particular corruption and judicial inefficiency, and in the enforcement of fair competition.

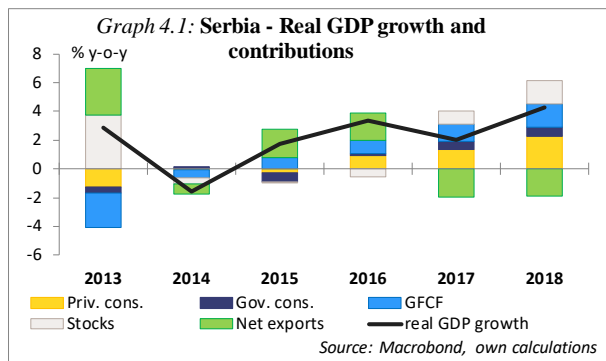
In order to improve the functioning of the market economy, Serbia should in particular:

- maintain the identified medium-term budgetary objective close to balance;
- strengthen fiscal rules by making them more binding and capable of anchoring fiscal policy;
- finalise the privatisation and restructuring process of the remaining state-owned banks;
- significantly increase funding and the implementation of active labour market measures adjusted to the needs of the unemployed.

Economic governance

The authorities remained committed to macroeconomic stability and continuing economic reforms, although some reforms have stalled. In July, after successfully completing a three-year Stand-By Arrangement with the International Monetary Fund, Serbia agreed to a new non-disbursing programme supported by a 30-month policy coordination instrument. The policy guidance jointly agreed at the May 2018 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented. The macroeconomic policy mix was appropriate and macroeconomic and fiscal indicators improved. However, the implementation record of structural reform has remained mixed. The efficiency and predictability of the institutional environment is not yet ensured and does not sufficiently support long-term growth. Weaknesses remain in the fiscal governance framework, the business environment, the public administration and the tax administration, and in the way the state intervenes and manages its presence in the economy.

Macroeconomic stability



The economy has shifted up a gear.

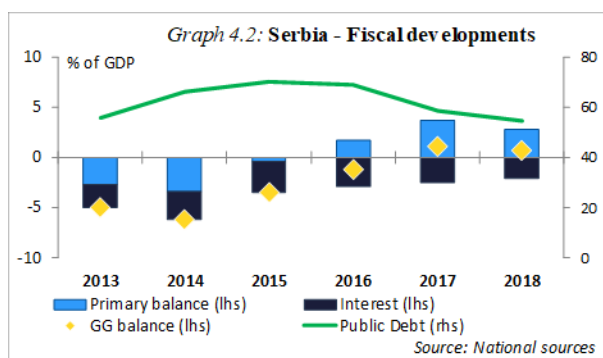
Economic growth accelerated in 2018, to over 4% from 2% in 2017, boosted by robust domestic demand and base effects. Investment activity, in particular, was very strong, benefiting from a number of factors: the low interest rate environment, higher growth expectations, past improvements in the business environment, increased capital spending by the government, and a stream of foreign direct investments. Rising domestic demand led to a strong growth in imports and

the contribution of net exports to growth turned negative as from 2017. After years of decline or marginal growth, household consumption has expanded steadily since the end of 2017. Prospects for consumption growth remain strong as the economic cycle matures and labour market conditions improve further. The income gap with the EU, however, remained broadly unchanged over the last decade — per capita GDP in purchasing power terms stood at 37% of the EU average in 2017.

External imbalances are on the rise but their financing remains healthy. Driven by a widening merchandise trade deficit, the current account deficit has nearly doubled since 2016, staying above 5% of GDP in both 2017 and 2018. The growing economy triggered a double-digit growth in imports of goods. Most of this increase, however, was in intermediate goods and energy, reflecting higher energy prices and expanding investment and exports. Export performance, a key indicator of international competitiveness, remained robust in 2018. Exports of manufacturing goods, which constitute the bulk of all exports, continued to expand. Exports increased across all sectors, except for food products due to a bad agricultural season in the previous year. The current account deficit was fully covered by large and broad-based net inflows of foreign direct investment. The official foreign exchange reserves remained adequate, covering more than twice the short-term external debt and around 5 months' worth of imports of goods and services.

Price pressures remained subdued and inflation expectations contained. Despite strong economic growth, inflation remained low in 2018, below the mid-point of the central bank's tolerance band of 3% ±1.5 pps. Price stability was supported by a continuously strong dinar exchange rate and steady fiscal performance. Although energy prices went up in the second half of the year, lower food prices helped contain inflationary dynamics. Contrary to previous years, the administered household electricity prices remained unchanged. The low and stable core inflation, which hovered around 1% for most of 2018, also attested the absence of inflationary pressures. Monetary policy has cautiously supported economic activity: the key policy rate of the central bank was cut twice by 25 basis points in March and April 2018 to 3.0%. In April 2018, the central bank also narrowed the interest rate corridor around its key rate from ±1.5 pps to ±1.25 pps. The central bank continued its frequent interventions on the foreign exchange market, buying a net EUR1.6 billion in 2018.

Major fiscal adjustment over previous years has significantly improved debt sustainability. In 2018, the general government budget ended in surplus for a second consecutive year, while the 2019 budget envisages a small deficit of 0.5% of GDP. The good fiscal performance has created room to unwind the crisis era pension cuts, increase capital spending and reduce, albeit only marginally, labour taxation. However, expenditure composition remained poor: the share of economically productive capital



expenditure is low in comparison to public infrastructure needs, in particular in environmental infrastructure, while discretionary current spending increased further from an already elevated level. The track record of prudent fiscal policy has played a major role in increasing confidence in the economy, supporting economic growth, and significantly reducing government debt. Government debt fell from a peak above 70% of GDP in 2015 to around 55% of GDP in 2018.

Delays in public sector reforms have prolonged long-standing inefficiencies and fiscal governance challenges. While revenue collection met and even surpassed expectations recently, the implementation of the tax administration reform remains crucial to sustain revenue performance and provide better service to taxpayers. The authorities are only slowly addressing weaknesses in budget planning and implementation. The extension of the problematic public employment freeze by another year undermines the quality of public service. Selective wage increases in 2019 and the postponement of the wage system reform have widened wage disparities across the public sector as well as pay gaps with the private sector. Envisaged improvements in the capital management process and in particular the establishment of a single mechanism for national investment prioritisation and planning are still pending. In addition, EU-funded projects are excluded from its application. In order to ensure a more efficient use of resources, existing parallel structures need to be merged into a single mechanism for prioritising all investments

	2010-15 average	2016	2017	2018
GDP per capita (% of EU-28 in PPS)	36,8	37,0	36,0	:
Real GDP growth	0,9	3,3	2,0	4,3
Economic activity rate of the population aged 15-64 (%) , total	:	65,6	66,7	67,8
<i>female</i>	:	58,1	59,6	60,6
<i>male</i>	:	73,1	73,8	75,1
Unemployment rate (%) , total	:	15,9	14,1	13,3
<i>female</i>	:	16,7	14,8	14,2
<i>male</i>	:	15,3	13,5	12,5
Employment (annual growth %)	:	5,6	2,8	1,4
Nominal wages (annual growth %)	5,7	3,8	3,9	6,0
Consumer price index (annual growth %)	5,8	1,6	3,0	2,0
Exchange rate against EUR	111,6	123,1	121,3	118,3
Current account balance (% of GDP)	-7,1	-2,9	-5,2	-5,1
Net foreign direct investment, FDI (% of GDP)	4,5	5,2	6,2	7,5
General government balance (% of GDP)	-5,0	-1,2	1,1	0,6
General government debt (% of GDP)	54,5	68,8	58,7	54,6

Source: Eurostat and national sources

regardless of the source of financing, in accordance with the public financial management reform programme adopted by the government. The system also needs to expand to cover other government-to-government projects that have been a recurring concern with regard to their transparency, cost efficiency and conformity with EU standards.

The budgetary framework continues to be only partially complied with, pointing at weakness in public finance management. There were no meaningful parliamentary debates on the draft annual budget. External stakeholders were not consulted on it despite legal obligations to include them in the process. The system of fiscal rules is weak as it is not sufficiently binding and relevant for policy-making. The work on their strengthening has stalled, although it remains a short-term government priority. Final annual budget reports are not presented to and adopted by the Parliament.

The macroeconomic policy mix remained appropriate. It helped sustain macroeconomic stability and supported the pick-up in economic activity. The prudent fiscal policy and cautious monetary policy helped contain the growing risks from the external environment, despite widening external imbalances and a marked pick-up in growth of private and public consumption. As in previous years, the continuation of economic reforms and their full implementation remain key to further strengthening the economy's potential and to supporting real convergence with the EU.

Functioning of product markets

Business environment

The business environment has improved somewhat amid a general slowdown in the reform momentum. In the first half of 2018, the number of total registered companies increased by 4.8 %: newly-registered companies went up by 4.2 %, while the number of companies that exited the market fell by 3.7 %. Over the last few years, Serbia has notably improved its standing in various international business rankings. However, the recent delays in the reform process resulted in the country sliding down in some of the latest rankings. Although restitution in kind has progressed, the deadline for issuing financial compensation in the restitution process has been further delayed for another 2 years, until 2021.

The institutional and regulatory environment remains weak. Business-related laws continue to be adopted under urgent procedure without the necessary consultation of interested groups, reducing predictability and quality of legislation. Delays in adopting secondary legislation continue to hamper the implementation of adopted laws. In general, contract enforcement is weak and the courts enforcing property rights remained overburdened. Fair competition is negatively affected by the large informal economy. The control of State aid is weak and its granting non-transparent, as the legislation allows for too many exemptions and the control body does not have all needed competences. The Commission for State aid control (CSAC) remains understaffed and is still not operationally independent. Decisions to grant State aid are not regularly notified ex ante to the CSAC by granting authorities. Granting of State aid seems to favour market incumbents and large investors. As a measure to fight the grey economy, the authorities have amended the Law on inspection supervision to permit supervision of unregistered activities. They also took steps to improve the coordination of inspections and to facilitate a risk-based approach by means of introducing a unified inspection information platform. After Serbia was put on the list of jurisdictions with strategic deficiencies by the Financial Action Task Force on money laundering in early 2018, the Serbian authorities took a number of measures to address the identified shortcomings.

State influence on product markets

State ownership in the economy has gradually declined over recent years, but indirect state presence in the economy remains large amid persistent governance weaknesses. The financial performance of SOEs improved, helped also by a cyclical economic upswing. Governance of these enterprises remains under strong political influence, including through the appointment of acting

managers, instead of using the prescribed nomination process. Although the general trend sees the state continuing to withdraw from direct involvement in the economy, in some product market segments, like cable television operators, the majority state-owned telecom operator has actually expanded its presence after several acquisitions. The share of administered prices remained broadly unchanged, at around 20% of the consumer basket.

Privatisation and restructuring

Privatisation of SOEs advanced, while restructurings progressed slowly. Since 2015, when the new privatisation law was adopted, more than 310 companies, mostly with zero or a small number of employees, have been put into bankruptcy. Other companies were privatised and non-EU investors acquired some of the largest firms in mining, metallurgy, and agriculture. Nonetheless, around 90 companies employing some 40,000 persons have yet to be resolved through either bankruptcy or privatisation.

Restructuring of key utility companies is still incomplete. The financial performance of key utility companies, particularly in the energy sector, has improved over the recent years, but their restructuring has advanced rather slowly. The state-owned power utility Elektroprivreda Srbije has to fully address its corporate governance issues and finalise the unbundling of electricity transmission and distribution operators in terms of organisation and decision-making. While long overdue, a change in the legal status to a joint stock company is envisaged in 2020. The company also needs to invest in securing new production capacities and refurbishing old ones. The financial consolidation of Srbijagas remains a key aspect of its reorganisation plan. Government support for servicing Srbijagas debt is planned to stop by the end of 2020. Serbia did not fully implement the third energy package and failed to unbundle Srbijagas and provide non-discriminatory third-party access to its transmission system.

Functioning of the financial market

Financial stability

Financial stability was preserved and the financial sector's performance improved. Supported by rising economic activity, the profitability of commercial banks remained high. Other indicators also show that the performance of the banking system was strong. Capital adequacy was high, well above the minimum set by the national bank and the implementation of the resolution strategy for non-performing loans (NPLs) supported their further reduction to 5.7% of total gross loans by the end of 2018. Liquidity, although declining, also remained high. With the view to addressing the persistently high degree of euroisation, the central bank and the government have revised their dinarisation strategy. A new NPL resolution strategy is envisaged as well, focusing on limiting the rise of new NPLs. The authorities have taken steps to start addressing the legacy NPLs in the portfolio of the Deposit Insurance Agency. The implementation of the strategy for banks in which the state has ownership continued, albeit with delays, and the state remains in control of key entities in both the banking and insurance sectors. The privatisation of Komercijalna banka (the third largest bank by assets) has been postponed to 2019.

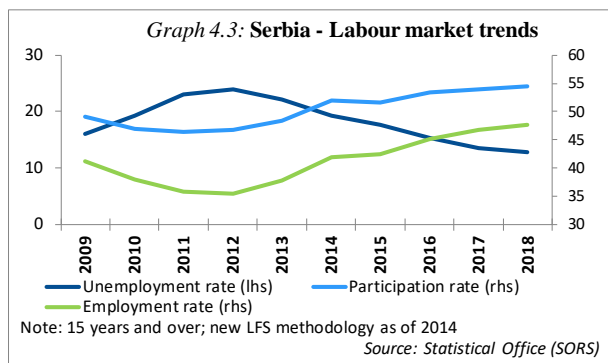
Access to finance

Access to finance improved. Foreign-owned banks continued dominating the financial system, holding around three quarters of banking system assets. Favourable financing conditions and higher economic activity have supported growth in lending. Credit expanded by double-digits for both corporates and households, excluding effects from exchange rate changes and NPL sales and write-offs. Despite the vigorous credit activity, the central bank estimated that the overall credit-to-GDP ratio is below its long-term trend and, therefore, has kept the countercyclical capital buffer unchanged at 0%. However, as vulnerabilities increased in some segments of the market, such as cash loans for households with long maturities, the central bank introduced new measures to curb risks from excessive loan growth in these

segments. It has also introduced a requirement for commercial banks to inform their clients about the possible risks of floating interest rates. There was no progress in establishing the legal framework for microfinance institutions. The ad-hoc and urgent adoption of a special law on converting mortgages denominated in Swiss francs into euros undermines the functioning of the financial market and came at significant cost for the budget.

Functioning of the labour market

The labour market has seen marked improvements over recent years, but structural problems and demographic challenges still need to be tackled. In 2018, on the back of stronger economic growth,



labour market indicators achieved their best performance since the start of the (revised) labour force survey in 2014. Activity and employment rates were at their highest, while unemployment (15 years and over) went down to 12.7%. Although long-term unemployment and female and young people unemployment continued their downward trend, the activity rate for young people has declined. The proportion of young people in the age group 15-24 not in employment, education, or training fell further to 16.5% in 2018. The

share of informal employment, two-thirds of which was in agriculture, fell to around 20% of the total. However, the labour force likely peaked as the declining working age population is taking its toll on labour supply. A steady population decline by 0.5% every year, along with emigration and the brain drain, especially of educated young people, remain key medium-to-long-term economic challenges. In addition, persistent skills mismatches and large regional disparities have continued to be a major labour market issue resulting in high structural unemployment.

Real wages have increased. The revival of economic activity and tighter labour conditions have pushed up real wages, although in 2018 their growth still remained moderate at around 4%. Although the authorities abolished the unemployment contribution paid by employers (0.75% of gross salary), the tax wedge remained disproportionately high for people with low salaries. In line with expectations for a rise in wages in the economy, the government increased the minimum hourly wage by 8.6% in 2019.

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

Serbia has made **some progress** and is **moderately prepared** to cope with competitive pressure and market forces within the EU. The structure of the economy improved further and economic integration with the EU remained high. However, despite some progress, the quality, equity and relevance of education and training does not fully meet labour market needs. Investment increased but, after years of underinvestment, remains insufficient to address infrastructure gaps. Although the cost of borrowing for small and medium-sized enterprises (SMEs) has declined recently, they still face a number of challenges, including a volatile business environment and unfair competition.

In order to improve competitiveness and long-term growth, Serbia should in particular:

- develop a single mechanism for prioritising and monitoring all investment regardless of the source of financing;
- unbundle Srbijagas and provide third-party access to gas infrastructure.

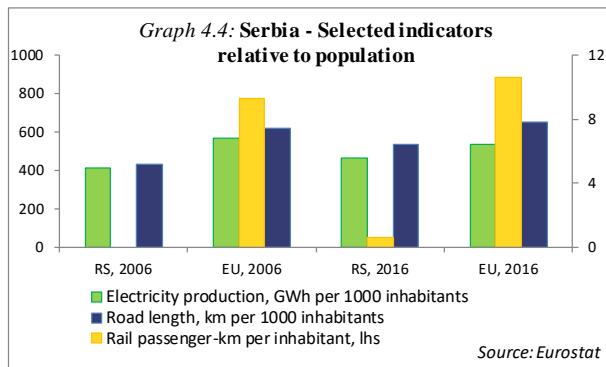
Education and innovation

Despite some progress, the quality, equity and relevance of education and training do not fully meet labour market needs. Public spending on education stood at around 3.1% of GDP in 2018, which is below the EU average of around 5% of GDP. Enrolment rates remained high in general in primary and lower secondary education, at close to 100%, and at around 90% in upper secondary level. Pre-primary enrolment lagged at some 60%, despite having increased in 2017. The gross enrolment ratio in tertiary education also increased over recent years to nearly two thirds. However, employers and recent graduates believe that the country's education institutions do not equip students with key transversal skills, such as problem solving and decision making. In line with national strategic documents and recently adopted legislation, the authorities are progressively updating curricula in all 12 years of general education. Teacher training is needed to support the implementation of new curricula and the development of students' key competencies. The introduction of the national dual education model is increasing in scope and aims to improve the relevance of vocational education. The institutional framework for implementing the recently adopted Law on national qualifications framework is being established. This framework is part of a progressive reform of the education system at all levels, including non-formal and informal learning.

The level of spending on research and development increased over recent years, although it remains low at 0.9% of GDP. The increase in expenditure came almost entirely from the private sector, while funding from the government budget was broadly stable at around 0.4% of GDP, providing less than half of total R&D financing in 2017. The number of scientific-research organisations stood broadly unchanged. However, the number of employees in research and development activity declined slightly, representing only 0.8% of total employment in 2017. In order to support innovation, Serbia introduced specialised instruments — collaborative grants for joint business-academia projects to promote and support business-academia collaboration and innovation vouchers. Following the establishment of a science and innovation park in Belgrade, three more are under construction in other cities.

Physical capital and quality of infrastructure

Investment increased but after years of underinvestment its level remains insufficient to address infrastructure gaps. Both public and private investment have been rising in the last couple of years. The



economy continues to attract significant foreign direct investment, which have been instrumental for the shift towards tradable sectors and higher exports. However, the share of total investment in the economy is still relatively low, under 20% of GDP, and the quality and quantity of physical infrastructure needs further upgrading. Despite recent increases, particularly in roads and railways, the level of government investment still does not correspond to the needs of the economy. In addition, the available fiscal space has been

used mostly for current spending and non-productive capital expenditure, instead of for more growth-friendly spending on infrastructure and basic public services.

The institutional framework supporting new investment is weak. Soft measures, like improving traffic management, maintenance and safety in all transport modes, and increasing energy efficiency and diversification could potentially improve the performance of the transport and energy sectors. The user-pay principle is not sufficiently applied when it comes to maintaining existing infrastructure and implementing new infrastructure investment plans. Transparency, assessment and prioritisation of investment needs are still weak. Public procurement rules are not always fully complied with, nor are they always fully compatible with EU standards, particularly in big infrastructure projects financed or implemented by non-EU companies.

The authorities have made digitalisation one of their top priorities. A new law on e-government was adopted in April 2018, which aims to enable simpler, more transparent and efficient functioning of electronic public services and to facilitate communication with the administration. The strategy for developing e-government for 2019-2021 has not yet been adopted. The application of the law is hampered by the lack of a fully developed legislative framework and the necessary secondary legislation. The information and communication sector continued expanding, increasing its share in the economy and in total exports. The share of households that have a computer and access to a broadband internet connection increased further to more than 72% in 2018. The share of individuals using e-commerce also steadily increased to some 55% in 2018, while the shares of those who have never used a computer or the internet halved over the last decade to less than 25%.

Sectoral and enterprise structure

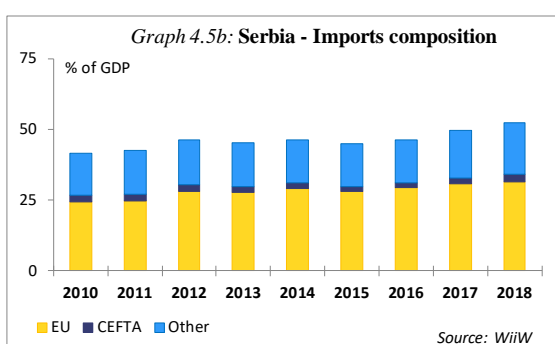
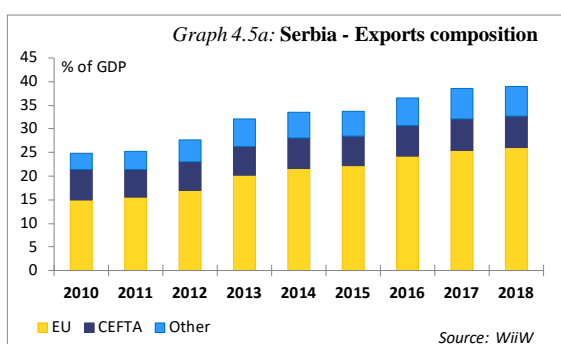
Construction and some services have increased their weight in the economy. Services are by far dominating the economy, providing more than 60% of total value added. Sectors like transportation, retail trade, and information and communication, benefited from the revival of economic activity and the steady expansion of international trade to increase their economic weight. Reflecting the new investment cycle, construction, which reached its lowest point in 2013, has recovered to above 4% of GDP. The performance of the agricultural sector remained volatile, mainly because of its very high dependency on weather conditions. Although it rebounded strongly in 2018, after a slump in the previous year, it has been on a downward trend over the last 5 years. The weight of industry levelled off or even declined

largely because of a drop in mining and quarrying activity and in the energy sector. The employment structure has changed as well: there was a steady fall in agricultural employment, which fell from nearly 20% in 2014 to some 15% in 2018, while there were increases in the share of employment in the industry and service sectors.

SMEs are the backbone of the economy. They provide 60% of total employment and turnover in the economy, and nearly half of the value added. SMEs are particularly active in construction, accommodation and food service, retail, and real estate. The authorities are implementing several programmes to support SME development, focusing on facilitating innovation, finance, and internationalisation. SMEs receive around 60% of new corporate loans. Their cost of borrowing has declined recently, although it remained above the cost for large companies. SMEs still face a number of challenges, including a volatile business environment and lack of non-bank financing. The Law on charges, adopted in December 2018, aims to reduce some of this uncertainty by consolidating all parafiscal charges and removing or merging some of them.

Economic integration with the EU and price competitiveness

Economic integration with the EU remained high. Serbia's financial system is dominated by commercial banks, and banks with majority ownership from EU countries hold more than 70% of all banking system assets. The EU is also by far Serbia's biggest trading and investment partner, accounting for almost two thirds of total trade and three quarters of net foreign direct investment inflows. It is followed by trade with the signatories of the Central European Free Trade Agreement (CEFTA) (excluding Kosovo), which represented slightly less than a fifth of total exports and around 4% of total imports in 2018. The imposition of a 100% tariff by Kosovo in late 2018 on imports from Serbia and Bosnia and Herzegovina affected Serbia's export of goods of around 1.1% of GDP per year. Serbia's national infrastructure for checking standards has improved over the last year, but it still does not fully support trading operators and there are non-tariff barriers impeding intra-regional trade as well as trade with the EU.



In 2018, trade openness rose further, above 110% of GDP from some 90% 5 years earlier as both imports and exports maintained strong growth. After a strong appreciation in the previous year, the dinar nominal and real effective exchange rate remained broadly stable in 2018.

4.3. CONCLUSIONS

As regards the economic criteria, Serbia has made some progress and is moderately prepared in developing a functioning market economy. External imbalances are on the rise, although their financing remained healthy. Price pressures remained subdued and inflation contained. Major fiscal adjustments over previous years have significantly improved debt sustainability. Financial sector stability was preserved and labour market performance has improved with the exception of the youth activity rate,

which declined. Major structural reforms of public administration, the tax authority, and state-owned enterprises advanced slowly, prolonging long-standing inefficiencies. The authorities are addressing weaknesses in the budgetary framework and its governance at a slow pace. The state retains a strong footprint in the economy and the private sector is underdeveloped and hampered by weaknesses in the rule of law and in the enforcement of fair competition.

Serbia has made some progress and is moderately prepared to cope with competitive pressure and market forces within the Union. The structure of the economy improved further and economic integration with the EU remained high. However, despite some progress, the quality, equity and relevance of education and training does not fully meet labour market needs. Investment increased but remains insufficient, after years of underinvestment, to address infrastructure gaps. Although the cost of small and medium enterprises borrowing has declined recently, they still face a number of challenges, including a volatile business environment and unfair competition.

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.

Economic governance has become even more central in the accession process in recent years. The Commission's monitoring takes place in two processes: the Economic Reform Programme exercise and the assessment of compliance with the economic criteria for accession. Each enlargement country prepares an annual Economic Reform Programme (ERP), which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

5.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

The Turkish economy is **well advanced**, but serious **backsliding** continued, leading to deeper concerns over the functioning of the country's market economy. A sharp deterioration in external financing conditions exposed vulnerabilities which have built up over the years. In response, the Turkish authorities took a range of policy actions that negatively affected the functioning of the markets, particularly interference with price formation and the introduction of constraints on the free use of foreign currency. Existing concerns regarding the independence of key economic institutions, including the independence of their staff, have deepened, in particular after the transition to the presidential system in which checks and balances were eroded.

The current account deficit reached a peak in the first half of 2018 before a strong correction set in as a result of the weakening economy and the fall in the Turkish lira (TL). The inflation rate jumped to levels far above the upper band of the target range following the currency crisis and years of high credit growth, high money growth and low real interest rates.

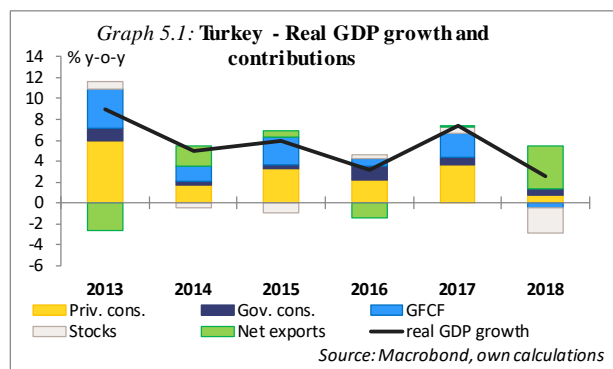
Fiscal, quasi-fiscal and regulatory measures stimulated the economy when it was in an upswing, combined with relatively easy monetary conditions. In the ensuing disorderly unwinding of imbalances, measures taken by the authorities have eroded the functioning of the market economy.

In order to improve the functioning of the market economy Turkey should in particular:

- increase fiscal transparency and credibility, promote domestic savings and reduce incentives for greater indebtedness of companies;
- improve the business environment, including by strengthening the rule of law and reducing the number of businesses remaining under trusteeship;
- unwind the measures that inhibit the free flow of foreign capital and reduce state influence in price setting;
- reduce informality in the labour market and develop more incentives for the participation of women in the labour market.

Economic governance

Turkey faced a sharp deterioration in its external financing conditions in the second half of 2018, which led to strong policy responses, some of which are hampering the functioning of the market economy. The long-running depreciation of the TL accelerated markedly in April 2018 and even more sharply in August 2018. Turkey’s high dependence on foreign financing exposed it to changes in investor sentiment. In response, the Turkish authorities, in addition to a series of mainstream policy measures such as an interest rate hike and the adoption of a fiscal consolidation plan, also undertook a range of actions that undermine the proper functioning of the markets. These include restrictions on the use of derivatives, requesting banks to charge below-market interest rates for mortgages, banning the use of foreign currencies in high-value transactions (car leases and real estate), blocking price hikes for specific consumer goods products, forced transfers of foreign currency proceeds into domestic currency, and a temporary change in the withholding tax for bank deposits. The Government also influenced price setting by coordinating a 'voluntary price reduction' while intensifying the sanctioning of price rises deemed excessive. At an aggregate level, the emergency measures have had limited impact on lowering inflationary expectations and reducing inflationary pressure. Concerns regarding the independence of economic institutions such as the financial supervisor (loosening of macro-prudential standards to stimulate growth), the national accounts office (dismissal of a senior staff member), and the central bank (missing the upper band inflation target by a wide margin for several years, switching between policy rate channels in the absence of economic rationale) have deepened. These concerns deepened further with the transition to the presidential system, in which checks and balances have been eroded. The policy guidance jointly agreed at the May 2018 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been implemented to a limited extent.



Macroeconomic stability

The Turkish economy slowed markedly in 2018 after strong growth in the preceding years as financial conditions sharply deteriorated in August. In 2013-2017, GDP grew by an average of 5.5% a year, and GDP per capita, calculated in Purchasing Power Standards (PPS) EUR, by 4.9%. Due to this high growth, per capita income converged significantly with EU levels, from 52% in 2010 to 65% in 2017. Loose financial conditions fuelled growth, in particular in the construction sector. However, this came at the cost of increasing macroeconomic imbalances, setting the scene for sharp depreciation of the TL and a strong deterioration in financial conditions and credit supply. While growth was still robust at the beginning of 2018 (7.1% year-on-year in the first quarter), the deceleration of the economy that started in the second quarter worsened in the third. An increase in net exports only partly offset a sharp contraction in domestic demand.

The current account deficit reached a high in the first half of 2018 of 8.0% of GDP before reversing to a surplus in the second half. The ratio of the current account deficit to GDP was 7.0% of GDP in 2013 and 5.6% in 2017, averaging 5.0% of GDP over this period. After reaching a high in the first half of 2018, the current account corrected following the sharp depreciation of the TL as imports contracted and exports increased. The services balance increased to 3.3% of GDP over the full year 2018, above the 2015

<i>Table 5.1:</i>	2010-15	2016	2017	2018
Turkey - Key economic figures	average			
GDP per capita (% of EU-28 in PPS)	60.0	64.0	65.0	:
Real GDP growth	7.4	3.2	7.4	2.6
Economic activity rate of the population aged 15-64 (%) , total	54.0	56.9	57.9	58.5
<i>female</i>	32.4	36.2	37.5	38.3
<i>male</i>	75.6	77.6	78.2	78.5
Unemployment rate (%) , total	9.6	10.9	10.9	11.0
<i>female</i>	11.2	13.9	14.2	14.0
<i>male</i>	8.9	9.7	9.6	9.7
Employment (annual growth %)	:	0.8	1.8	1.0
Nominal wages (annual growth %)	:	20.2	14.6	:
Consumer price index (annual growth %)	:	7.8	11.1	16.3
Exchange rate against EUR	2.64	3.71	4.56	5.68
Current account balance (% of GDP)	:	-3.8	-5.6	-3.6
Net foreign direct investment, FDI (% of GDP)	1.2	1.6	1.4	1.7
General government balance (% of GDP)	:	-1.3	-1.6	-2.6
General government debt (% of GDP)	:	28.3	28.3	31.1

Source: Eurostat and national sources

high of 2.9% of GDP. A current account deficit of 3.6% of GDP was recorded over the full year 2018. The services balance improved, with a recovery of tourism in Turkey, although individual tourists spent on average 15.5% less in 2017 than in 2013 (-18.5% Q1-Q3 2018 vs. Q1-Q2 2013).

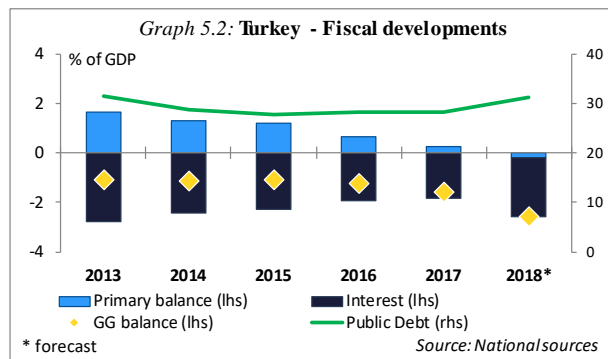
Capital flows to Turkey have been volatile, with large shifts within categories. Foreign direct investment flows (FDI) have been the most stable, but continue to play a relatively limited role, registering a net inflow of 1.0% of GDP in the first three quarters of 2018. Net portfolio flows into Turkey surged in 2017 to 2.8% of GDP, but reversed and registered an outflow of 0.7% of GDP in the first three quarters of 2018. Turkish companies also increasingly financed themselves through trade credit, receiving more trade credit than they extended. Trade credit flows reversed in the third quarter however (-0.7% of GDP vs. +0.4% in 2017). The ratio of official reserve assets to short-term debt declined from 108% (7 months of imports) in 2016 to 97% (5 months of imports) in 2017, and further to 83% (5 months of imports) in 2018. Turkey's gross international debt grew from 40.1% of GDP in 2013 to a high of 52.9% in the first three quarters of 2018.

Inflation increased markedly from the low double figures in 2017 to over 20% following the sharp depreciation of the TL in August. Inflation increased to a high of 25.2% year-on-year in September, before falling to 19.7% in February 2019. The Central Bank of the Republic of Turkey (CBRT) has used different policy instruments to influence interest rates. The economic rationale for switching between these interest rate channels is not obvious, and the use of the late liquidity window (LLW) emergency facility increased the risks of inappropriate funding levels and moral hazard. By the end of 2017, the LLW had become the only financing channel. In May-September 2018, the central bank rapidly alternated between different instruments, announcing first a central repo rate, switching to overnight

lending and then reverting to repo until it increased its main policy rate to 24%, well above market expectations.

Fiscal and quasi-fiscal policy have worked pro-cyclically and increased government liabilities. The Government has financed large infrastructure projects through Public Private Partnerships (PPPs), increasing government contingent liabilities. It has also stimulated credit growth through government credit guarantees, and state-owned banks have been at the forefront of increased lending. The primary budget balance fell from 1.7% in 2013 to 0.2% of GDP in 2017. A benchmark fiscal rule was considered but never implemented. There is no independent fiscal council, and medium-term projections, which have been targets rather than conservative estimates, now fall directly under the responsibility of the President.

The budget deficit grew due to pre-election spending. The central government budget deficit outcome was 2.4% of GDP. Both primary expenditures and revenues increased, but expenditures increased at a higher pace. General government debt stood at 32.6% of GDP in the third quarter of 2018, up from 28.3% of GDP in 2017. Foreign currency denominated debt was stable at 39% of all debt from the first quarter. With the transition to the presidential system, important changes have been made to Turkey's budgetary framework, which raises concerns about accountability and the transparency of public finances.



Budget preparation, implementation and audit are centralised under the President, as are off-balance-sheet items such as the Turkish Wealth Fund.

The macroeconomic policy mix led to an unsustainable credit-fuelled economic boom in 2017 and early 2018 that ultimately led to a further increase in vulnerabilities. The institutional setting weakened with the transition to the presidential system and, despite a large increase in the nominal policy interest rates, the real interest rate remained close to zero throughout 2018. However, in a reaction to the crisis, the Government announced an austere fiscal agenda which, together with reduced political tensions with Turkey's major allies and strongly positive real interest rates, worked to restore market confidence. Measures to stabilise the financial sector by focusing on recapitalising banks and improving their asset quality were announced in April 2019.

Functioning of product markets

Business environment

Starting a business has become easier. The Government has made good progress, having legislated to improve the investment environment, especially by reducing and facilitating bureaucratic procedures and lowering costs for starting a business and obtaining construction permits. The average cost of starting a business fell from 12.6% to 10.6% of per capita income in 2018. The number of newly created businesses grew by 17% year-on-year between 2017 and 2018. Market exit has remained costly and time-consuming. While some aspects have been simplified, insolvency procedures still last an average of five years and the recovery rate fell slightly further between 2017 and 2018, from an average of 15.3% to 14.7%. The number of company bankruptcies decreased by 7.1% between 2017 and 2018.

The management of numerous companies has been transferred to the trusteeship of the Savings Deposit Insurance Fund (TMSF). As of 13 November 2018, 1,008 companies based in 42 provinces

across Turkey with a total asset value of $\text{₺}55.9$ billion (EUR 8.8 billion) and a total of 45,364 employees had been seized or had a trustee appointed since the coup attempt. In the new presidential system, the TMSF has been tied to the presidency. Furthermore, the President now also has the authority to appoint the Head of the TMSF and its members. Turkey does not score well in international business environment rankings, and its position in the judiciary components of these rankings is deteriorating.

The informal sector remains large, even if it is being reduced. Turkey has reported a decline in the informal economy's share of GDP from 32% in 2002 to 27% in 2017. Informal employment has declined from 45.4% of total employment in 2007 to 34% in 2017. Turkey put a lot of effort into receiving and addressing the needs of almost four million refugees, but the high number of refugees has exacerbated the problem of informal employment. From January 2016, refugees fulfilling certain eligibility criteria could apply for work permits. The uptake was relatively limited in the first year, in part because of stringent requirements. Turkey has also allowed the creation of many new businesses headed by Syrians under temporary protection. Turkey's performance as concerns corruption has been deteriorating over the past five years [see Chapter 23].

State influence on product markets

The Government has stepped up its interventions in the price-setting mechanism in key sectors. Around 30% of the consumer price inflation basket in Turkey is composed of goods whose prices are set or heavily influenced by public authorities, either directly or indirectly (price limits, tax rate adjustments). This represents an increase from the 25% reported last year. In October 2018, the government launched a full-scale programme to fight inflation by inviting companies to cut prices on consumer goods by at least 10% until the end of the year. In August 2018, amid growing concerns over the risks of pricing behaviours (especially significant price hikes and stockpiling), the Ministry of Trade introduced an amendment to the Regulation on commercial advertising and unfair commercial practices. According to this new legislative framework, price hikes not justified by a rise in input costs or by the exchange rate are considered unfair commercial practices. Measures to boost competition, however, would be more appropriate than direct government interference in price setting. The Food and Agricultural Product Markets Monitoring and Evaluation Committee is seeking to contain the rise in food prices by improving supply conditions for unprocessed food products.

There has been backsliding in improving the transparency of State aid. Legislation to implement the State Aid Law, originally scheduled to be passed by September 2011, has still not been adopted. 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 with the *acquis*. Additionally, Turkey has abolished the administrative structure responsible for implementing State aid legislation, and fully transferred its mandate to the Economic Policies Council and to the President, who is also the appointing authority for this Council's members. Thus, the organisational structure established for the purposes of implementing the Law has been dismantled, and the current structure is not considered to be operationally independent.

Privatisation and restructuring

The pace of privatisation has slowed considerably, accelerating the downward trend of previous years. The total volume of completed privatisations fell from \$1.3 billion (about EUR 1.2 billion) in 2016 to \$224 million (about EUR 188 million) in 2017. The privatisation of sugar factories represented by far the largest portion of privatisation revenues in 2018. The share of the energy sector (hydropower plants) in privatisation tenders remains high. Network sectors have been liberalised, with the exception of postal services and railways. Government assets within the scope of the Turkish Sovereign Wealth Fund (TWF) appear to be ring-fenced from privatisation. Under the presidential system, the Fund has been affiliated to the Presidency and the mandate of the Prime Minister on the TWF has been transferred to the President. As a result, the strategic investment plan of the TWF requires the President's approval. Furthermore, the President is authorised to transfer public assets to the Fund and to nominate the auditors for it. The

President has become the chairman of the Executive Board of the TWF and has appointed the Minister of the Treasury and Finance as the Fund's vice- chairman. Concerns over auditing of the TWF have not been addressed. Borrowing by the TWF would increase government debt. Government revenues as a share of GDP stood at 31.4% in 2017.

Functioning of the financial market

Financial stability

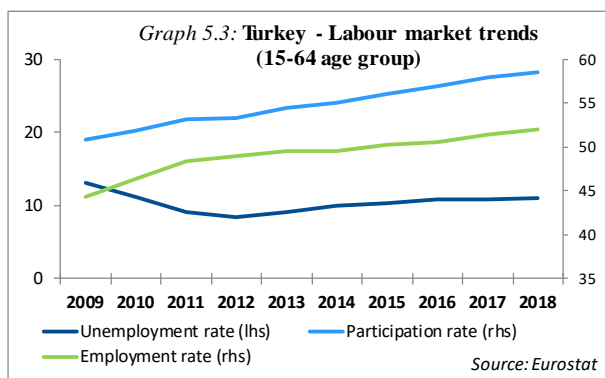
The financial sector performed generally well and demonstrated resilience during a period of high volatility in capital flows and the TL exchange rate. Credit growth started to accelerate at the end of 2016, and continued to do so in the first half of 2017 when the Turkish non-monetary authorities provided policy stimulus through a relaxation of the macro-prudential regulation and an expansion of government credit guarantees. As inflation started to pick up during 2017, the policy rate did not keep up and the realised real interest rate declined while inflation expectations increased. This likely added to the policy stimulus and the resurgence in credit growth. From the end of 2017, credit growth lost momentum and rapidly declined throughout 2018. The banking sector's loans-to-deposits ratio stood at 117.6% in December 2018. The sector's capital adequacy ratio increased from 15.6% to 16.8% between 2016 and 2017 and further to 17.3% by December 2018. The proportion of non-performing loans (NPL) of total banking sector loans remained relatively low, at 3.9% in December 2018. These financial soundness indicators, however, benefited from changes in risk classification. A stress-test performed by the financial supervisor at the end of December 2018 received criticism for lack of transparency.

Access to finance

Banks have continued to dominate the financial sector. Over the past five years, banks' credit extension to the private sector increased from 51.2% of GDP in 2013 to 63.6% in the first three quarters of 2018. Their rapid credit expansion continued in 2017 (+21% year-on-year) and in the first half of 2018 (+21%). In the second half of 2018, loan growth stalled in nominal terms and declined strongly in real terms. Compared to the EU, banks offer more loans to the non-financial corporate sector. The number of banks active in Turkey has remained relatively stable, at around fifty. Interest rate spreads between commercial loans in foreign currency and deposits have been relatively stable over the past five years, at around 2 percentage points, and increased somewhat towards the end of 2018. The Government has continued to use the Credit Guarantee Fund to support SMEs and to provide a boost to the economy, for instance by agreeing in May 2018 to introduce a loan guarantee package for businesses worth **₺35 billion**. In May 2018, the Government introduced stricter regulation of the use of foreign currency borrowing by the corporate sector, which should help limit its exposure to exchange rate fluctuations. While this will benefit the non-financial corporate sector, part of the losses on existing foreign currency loans will be borne by the banking sector. Access to foreign finance for smaller companies is now via the banking sector, and is dependent on the sector's access to international capital flows and its financial stability.

Functioning of the labour market

Unemployment remained stubbornly high during the past few years of strong economic growth, and has started to rise with the turning of the economic cycle, pointing to continued challenges in the labour market. Although the unemployment rate for 15-64 year-olds remained broadly at the same level in 2017 and 2018, this hides a sizable fluctuation within these two years. The unemployment rate fell by 3 percentage points in 2017 and grew by 3 percentage points in 2018. The unemployment rate for women (14.2% in 2017) remains significantly higher than for men (9.7% in 2017). Female unemployment rates have fluctuated more throughout recent economic developments than male ones. The unemployment rate for people with a higher level of education reached 12.4% in August 2018. Turkey also suffers from a high level of youth unemployment (15-24 years). This stood at 20.3% in 2018, representing a decrease of 0.5 percentage points compared with 2017. A quarter of young people are not in employment, education or training (NEET).



The labour force participation rate is increasing, however, but the gender employment gap persists. Driven by a growing working-age population, the labour force participation rate continued to increase from 58.0% in 2017 to 58.5% in 2018. The overall employment rate for 15-64 year-olds increased from 51.5% in 2017 to 52.0% in 2018, with a large difference between men (70.9%) and women (32.9%). Undeclared work remains widespread, with one third of the workforce still in informal employment. The minimum wage has risen over the years in real terms, despite increasing inflation. This complicates the reduction of the informal sector.

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

Turkey has made **some progress** and has a **good level of preparation** in achieving the capacity to cope with the competitive pressure and market forces within the EU, with improvements in energy sector and some advances in spending on R&D, education and physical capital. Turkey is well integrated with the EU market in terms of both trade and investment. However, significant weaknesses exist as regards the quality of education and gender equality in education, as well as the level of innovation, the energy sector and infrastructure. There was no progress on last year's policy recommendations

In order to improve competitiveness and support long-term growth, Turkey should in particular:

- increase enrolment in education and improving the quality of secondary education;
- remove trade barriers or equivalent that are not in conformity with the EU-Turkey Customs Union, including in public procurement, forced localisation schemes for investment and additional duties on imports from non-EU countries.

Education and innovation

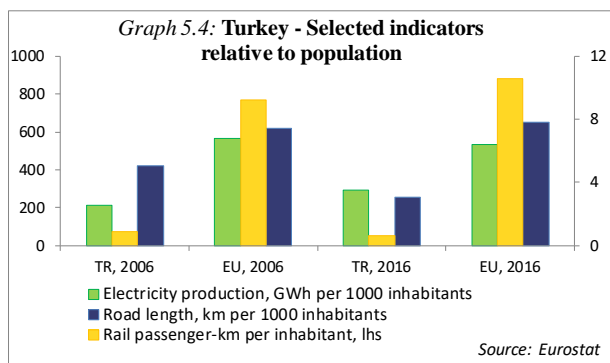
Significant problems remain in education in terms of both quality and access, which is more difficult for girls. The Global Competitiveness sub-indices for the quality of education ranks Turkey 101

out of 133 countries, and 131 out of 144 countries for the gender gap. Total expenditure in 2017 was €176.5 billion, representing an increase of 9.8% compared to 2016. Expenditure on education as a percentage of GDP was 4.7% in 2016 and 4.2% in 2017 (EU average 5.0%, with different demography). The net enrolment rate for pre-school education for the age group 5 increased from 58.8% in 2017 to 66.9% in 2018. The net enrolment rates in primary school (first 4 years) increased from 91.2% in 2017 to 91.5% in 2018, but fell for lower secondary school (second 4 years) from 95.68% to 94.47%. Parents have two choices: they can send their children to either pre-school or primary school at the age of five. Most parents choose pre-schools instead of primary schools. In secondary education (final four years), the net enrolment rate increased from 82.5% in 2017 to 83.6% in 2018. A mismatch continues between the requirements of the labour market and the skills produced by the education system. PISA scores (Programme for International Student Assessment) are relatively low in Turkey (science literacy score of 425 in 2015) in comparison with the OECD average (493) and the EU.

Research and development (R&D) expenditure increased from 0.86% of GDP in 2014 to 0.96% in 2017, but remained well below the Government’s current target of 1.8% by 2018 (which was defined using the old national accounting methodology). This is also well below the EU average. About half of this investment came from the private sector. Despite recent initiatives, cooperation between research institutions and the private sector is still limited.

Physical capital and quality of infrastructure

Improvements in the country’s physical capital have been modest. Total investment increased from 29.3% in 2016 to 30.0% of GDP in 2017 (28.5% of GDP in 2013). The share of gross fixed capital formation by the government GDP increased from 5.2% in 2016 to 6.6% in 2017 (4.4% in 2013), while private-sector investment decreased by 0.7% of GDP between 2016 and 2017. In order to control public spending, the Government has announced the suspension of investment projects for which the tender process has not yet been launched or has started but not yet been finalised.



Some progress was made in the energy sector, particularly in the gas market. A positive development is the launch of Turkey's natural gas spot trading platform, operated by the Energy Exchange EXIST. Further progress is needed, however, to open the natural gas market and create competition for the state-owned enterprise BOTAŞ. Since 2016, the Turkish Electricity Transmission Company (TEİAŞ) has been an observer at the European Network of Transmission System Operators for Electricity (ENTSO-E) which allows

market players to freely import and export electricity between the EU and Turkey, thus improving security of supply.

In telecommunications, the number of broadband internet subscribers reached 71.8 million. Mobile broadband penetration significantly increased to 73.1%, though it is still below the OECD average of 102.4%. The share of households with access to the internet at home grew from 80.7% to 83.8% between April 2017 and April 2018. Over the same period, internet usage by individuals aged 16-74 increased from 66.8% to 72.9%. Within 2 years of implementation, the number of 4.5G subscribers reached 68 million. No further progress has been made on aligning telecommunications legislation with the EU framework. As a source of concern, Turkey still needs to amend the Internet Law in line with UN and Council of Europe recommendations.

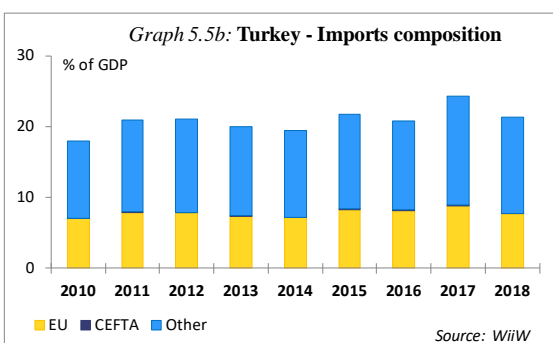
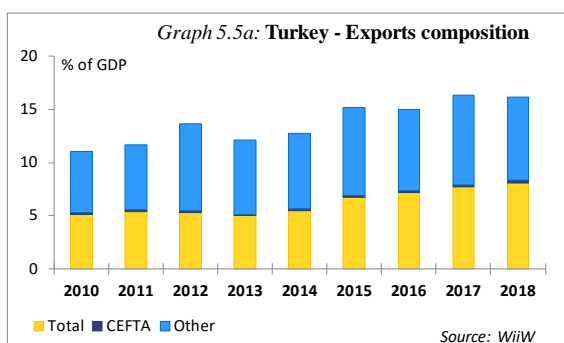
Sectoral and enterprise structure

The sectoral breakdown of employment growth shows a continued shift towards the services sector, which accounted for 53.7% of total employment and 61.6% of GDP in 2017. Industry accounted for 19.1% of employment and 20.7% of GDP, while agriculture employed 19.4% of the workforce and produced 6.1% of GDP. This confirms the higher share of industry in value added recorded over the past five years. Services contributed by far the largest part of value added over the same period, with a stable share of 61-62% of total value added.

SMEs employ around three quarters of Turkey's workforce and generate more than half of the economy's total value added. Turkey continued to implement various corporate schemes, mostly targeting SMEs. The scope of schemes concerning the organisation of sectoral national fairs and participation in international fairs, market research and market entry, investment support for centres of attraction, industry areas, organised industrial zones, technology development zones, support for tourism operators and Treasury support for venture capital funds was further extended to cover a wider range of beneficiaries and activities. Financial institutions do not offer as much long-term funding to SMEs as they do to large corporations. A large proportion of SMEs will no longer be able to borrow in foreign currency. According to a protocol signed in January 2018, further Treasury support of about EUR 9 billion was made available for SMEs through the Credit Guarantee Fund. This has further stimulated the growth in lending to SMEs.

Economic integration with the EU and price competitiveness

Turkey's trade integration with the EU is high and increased further in 2017 and 2018. Turkey is the EU's fifth largest trading partner, and the EU remains by far Turkey's largest trading partner. The share of Turkish exports going to the EU grew from 47.1% to 50%, while the share of Turkish imports coming from the EU declined marginally from 36.4% to 36.2% between 2017 and 2018. The EU also remains the largest source of foreign direct investment (FDI) in Turkey, with a 71% share of stocks in 2017, although this is lower than 2013 (77%). About half of trade related to global value chains (GVCs) is with the EU. The so-called backward participation in GVCs with low value added and low technology content is particularly important in trade with Asia, whereas the integration with EU GVCs is more balanced between backward and forward participation thus contributing to value added. Irrespective of the obligations under the Customs Union with the EU, Turkey has put up several trade barriers within the Customs Union, including in public procurement, forced localisation schemes for investment and additional duties on imports from non-EU countries.



Turkish openness, measured as exports and imports over GDP, stood at 54% in 2017. This is a relatively high figure compared to the past two decades. Price competitiveness benefited from the continuous depreciation of the TL in 2017; nominal effective depreciation (NEER) of 18% and real effective appreciation (REER) of 15% on the basis of unit labour costs, which accelerated in 2018 (NEER -24%, REER -15%).

5.3. CONCLUSIONS

Regarding the economic criteria, serious backsliding continued in the Turkish economy, leading to deeper concerns over the functioning of the country's market economy. In 2018, a sharp deterioration in the external financing conditions exposed vulnerabilities built up over years. In response, the Turkish authorities took a range of policy actions that have negatively influenced the functioning of markets, more importantly, by interfering with price formation and introducing constraints on the free use of foreign exchange. Concerns regarding the independence of key economic institutions have deepened. The current account deficit reached a peak in the first half of 2018 before a strong correction set in as a result of the weakening economy and the fall in the lira. The inflation rate jumped far above the upper band of the target range following the currency crisis and years of high credit growth, high money growth and low real interest rates. There was no progress in improving the transparency of state aid.

Turkey has made some progress and has a good level of preparation to cope with competitive pressures and market forces within the EU. Turkey is well-integrated with the EU market in terms of both trade and investment. Improvements were made in the energy sector, as well as some advances in spending on research and development, education and physical capital. However, there are persistent problems with the quality of education and gender equality.

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.

Economic governance has become even more central in the enlargement process in recent years. The Commission's monitoring is mainly done through two processes: the Economic Reform Programme (ERP) and the assessment of compliance with the economic criteria for accession (see below). Every year, each enlargement country prepares an ERP, which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

6.1. INTRODUCTION

Bosnia and Herzegovina is a relatively small economy with a population of approximately 3.5 million, living on a territory of around 51 000 square kilometres. This corresponds to about 0.7% of the EU-28 inhabitants, while the country's gross domestic product (GDP) at current prices of about EUR 17 billion represents only 0.1% of the EU-28 GDP. The country's GDP per capita in purchasing power parity terms has increased slightly in the last 10 years, from about 29% of the EU-28 average in 2008 to 32% in 2017.

The SAA stipulates that the EU and Bosnia and Herzegovina will facilitate the process of economic reform by cooperating to improve understanding of the fundamentals of their respective economies and the formulation and implementation of economic policy in market economies.

According to the constitutional and legal framework, the competences for the areas covered by the economic criteria are spread over the state level, the level of the two entities, Brčko District, but also cantonal and municipal levels. Monetary policy is one of the few areas of the economic criteria in which the main competences are at state level, with the Central Bank. Furthermore, the competences on trade policy, on indirect taxation and on external representation are allocated at the state level. However, some competences of importance for the financial sector's stability, such as banking sector supervision, are located at entity level. Competences related to economic policy are largely located at the level of the two entities and Brčko District, while competences related to education are located either at entity level, or, in the case of the Federation, at cantonal level. As regards economic policy, the main state-level actors are the Ministry of Finance and Treasury, the Directorate for Economic Planning - a permanent body of the Council of Ministers responsible for administrative coordination and monitoring - and the Fiscal Council. The Fiscal Council is tasked with coordinating fiscal policy in Bosnia and Herzegovina in order to ensure macroeconomic and fiscal sustainability of the State, the entities and Brčko District. However, in contrast to fiscal councils in the European Union, the Fiscal Council of Bosnia and Herzegovina is not independent and has primarily a coordinative role. At the level of the *Republika Srpska* entity, economic policy is the responsibility of the Ministry of Finance, while other ministries are in charge of particular aspects of the economy. In the Federation entity, the Institute for Development Programming is in charge of preparing economic policy, while the Ministry of Finance is responsible for fiscal policy. In Brčko District, the Directorate of Finance is responsible for this. The only authority responsible for issuing currency and for monetary policy is the Central Bank.

6.2. ASSESSMENT IN TERMS OF THE COPENHAGEN CRITERIA

6.2.1. The existence of a functioning market economy

The existence of a functioning market economy requires that prices, as well as trade, should be liberalised and that an enforceable legal system, including property rights, is in place. Macroeconomic stability and a consensus on economic policy enhance the performance of a market economy. A well-developed financial sector and the absence of significant barriers to market entry and exit improve the efficiency of the economy.

Economic governance

The transformation into a functioning market economy is frequently delayed by political stalemates and an insufficient focus on investment and education. Despite a general acceptance of the main principles of a market-based economy, frequent short-term-oriented political disputes have resulted in delays and interruptions of agreed and long-overdue reform projects. During the last 10 years, the country signed with the IMF two stand-by arrangements (in 2009 and 2012) and one agreement on an extended-funds facility (EFF) in 2016. This facility is still in place, although so far only one review has been completed. Overall, cooperation with the International Financial Institutions helped to overcome adverse external shocks; to keep public finances on a sustainable path, to strengthen the financial sector's resilience; to proceed with public sector reforms; and to prevent the build-up of external imbalances. However, due to frequent political gridlocks, progress with IFI support programmes has been slow.

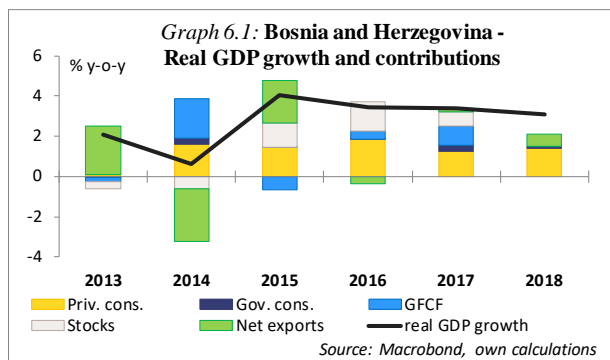
Since 2006, the country has participated in the EU's multilateral pre-accession economic policy surveillance exercise for candidate countries and potential candidates. So far, the level of compliance with the exercise's requirements has remained low, pointing to significant weaknesses in administrative coordination and cooperation and policy formulation. In particular, insufficient cooperation among the key stakeholders has prevented substantial improvements. Furthermore, the implementation of the latest policy guidance adopted jointly in 2018 by the authorities and the EU has remained limited. In 2015, the authorities started to implement an ambitious 'reform agenda'. In spite of delays in implementation, some important and often painful decisions were taken - for example, creating more flexible labour market legislation and better aligning financial sector regulations with international standards. Following the expiration of the 2015-2018 'reform agenda', a new set of socio-economic reform measures needs to be agreed and implemented by the governments at all levels in the country, in full alignment with the policy guidance set out in the joint conclusions of the economic and financial dialogue based on Bosnia and Herzegovina's Economic Reform Programme.

Overall, frequent political stalemates and a lack of cooperation among key stakeholders lead to overdue reforms being frequently delayed. As a result, the efficiency of economic governance, in particular with respect to proceeding with structural reforms, is very limited. The weakness of economic governance and cooperation also has negative effects on the availability of countrywide statistics, which strongly impedes the assessment of the country's compliance with the EU accession criteria.

Macroeconomic stability

During the last 10 years, the economy has experienced several external shocks, such as the 2008-2009 financial crisis, the international growth slowdown in 2012 and adverse weather conditions in 2014. Overall the economy has demonstrated a remarkable degree of shock resilience. Despite this, the economy shows a rather low overall growth momentum, in particular when taking into account the relatively low income level, with per capita GDP (expressed in purchasing power standards) at 32% of the EU-28 average in 2017.

Largely as a result of those external shocks, average annual output growth during the last 10 years has been at around 1.5% only. Private consumption was a key driver of growth before the financial crisis and



has been since 2014. Investment has at times played an important role, such as in 2014, when substantial (largely foreign-financed) funds were used to repair flood damage. However, strong domestic demand also translated into high imports and relatively high external imbalances, which were largely financed by workers' remittances. Exports also played an important role as growth drivers, in particular during the last 3 years, however, partly reflecting a favourable external environment.

External imbalances have declined, benefiting from strengthening external and moderating domestic demand. During 2009-2018, current account deficits gradually narrowed, declining to around 4% of GDP by 2018. The level of the underlying trade deficit has remained quite high, dropping from 29.4% of GDP in 2009 to around 22% in 2018. This high deficit has been largely counter-balanced by significant inflows of current transfers, mainly in the form of workers' remittances, accounting for more than 10% of GDP. Furthermore, Bosnia and Herzegovina usually achieves a surplus in the service balance, reflecting the effect of providing construction services abroad, as well as substantial net inflows from tourism. Net foreign direct investments remained relatively low at less than 3% of GDP during the last 10 years, probably as a result of factors such as the country's poor business environment and its fragmented markets. The main areas of investment have been the manufacturing sector, in particular the coal and food industries, the financial sector, trading and the electricity sector. While at the beginning of the observation period foreign direct investment (FDI) was largely driven by privatisations (of a telecom

<i>Table 6.1:</i>	2010-15	2016	2017	2018*
Bosnia and Herzegovina - Key economic figures	average			
GDP per capita (% of EU-28 in PPS)	30,0	31,0	32,0	:
Real GDP growth	1,4	3,1	3,2	3,1
Economic activity rate of the population aged 15-64 (%), total	54,0	54,2	54,5	54,2
<i>female</i>	41,6	41,9	42,7	41,8
<i>male</i>	66,5	66,2	66,1	66,4
Unemployment rate (%), total	27,5	25,5	20,7	18,4
<i>female</i>	30,2	30,2	23,3	20,3
<i>male</i>	25,9	22,6	19,0	17,2
Employment (annual growth %)**	-0,7	-2,6	1,9	0,7
Nominal wages (annual growth %)	1,2	0,9	1,6	3,1
Consumer price index (annual growth %)	1,0	-1,1	1,2	1,6
Exchange rate against EUR	1,96	1,96	1,96	1,96
Current account balance (% of GDP)	-6,8	-4,5	-4,9	-4,2
Net foreign direct investment, FDI (% of GDP)	2,0	1,6	2,1	2,3
General government balance (% of GDP)	-1,5	1,2	2,6	:
General government debt (% of GDP)	35,4	40,5	36,1	35,9

Source: Eurostat and national sources

* National sources

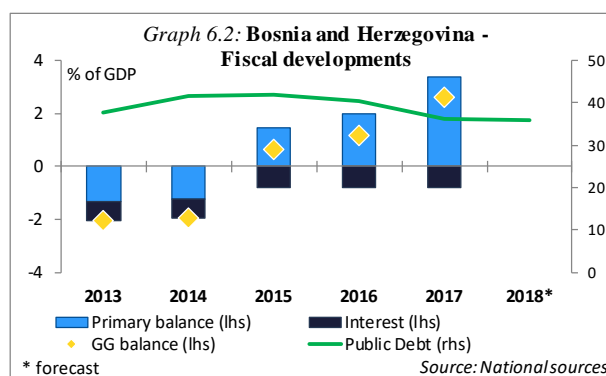
** LFS, including employed, self-employed and family workers

company and two oil refineries), in recent years FDI inflows largely consisted of reinvested earnings, while green field investment has remained very low, with the exception of some tourism projects. Largely thanks to the stable inflow of working remittances and improving tourism revenues, net foreign exchange reserves continued to increase over the last 10 years, reaching some 35% of GDP at the end of 2018.

Monetary policy has supported stability, based on the currency board arrangement as a key anchor. The Central Bank was established in 1997. Its mandate is to focus on providing monetary stability, in particular through foreign exchange rate stabilisation. The Central Bank also coordinates the work on financial stability, while its role concerning banking sector supervision is more limited. Overall, the Central Bank’s analytical capacities are limited. The currency board arrangement was adopted when the Central Bank was established, and has been in place ever since. Initially, the anchor currency was the German Mark, which since 1 January 1999 has been replaced by the euro. This approach has served the economy well so far. However, this arrangement also implies that the burden of adjustment to external shocks has to be accommodated by other policy areas, in particular responsible fiscal policy. This necessitates the building-up of sufficient fiscal buffers and a stronger emphasis on medium-term stability, as well as structural reforms to improve the functioning of markets.

Price stability has been largely maintained. In contrast to the high inflation experienced before independence, inflation has remained under control over the last 10 years. On average, consumer prices have risen by 0.7% annually in this time span with a period of a slightly declining overall price levels in 2013-2016. As a small, open economy with a fixed exchange rate with its main trading partner, domestic inflation is largely driven by import prices, which have generally been low during the last decade. Private sector wage agreements have tended to result in low wage increases, reflecting rather low productivity growth. However, there are serious issues with the quality of price indices, resulting from an insufficient resource allocation at the country’s statistic office and a lack of cooperation from some data providers. Measurement errors in this area have major negative knock-on effects on other areas of economic policy, such as on wage formation and thus on households’ real disposable income.

The general government accounts remained largely balanced, although the quality of fiscal governance has remained low. Over the last 10 years, public finances have benefited from solid revenue growth, relatively stable output growth and measures to improve tax collection, while growth of spending on public sector wages has remained contained. The country’s general government revenues are largely based on indirect taxes, which account for more than 40% of total revenues. Those revenues are collected centrally, while the other taxes are mainly defined, collected and spent on the lower levels of government. The current system of public sector accounting is not aligned with EU standards. In particular, the integration of public enterprises in the current public sector accounting is unclear. As a result, the actual levels of general government balances and of public debt in terms of European standards (ESA 2010) are difficult to specify. Overall, the quality of fiscal governance is low, with a lack of medium-term planning and a strong focus on maintaining current spending patterns, in particular on public sector wages and social transfers. This frequently results in delaying much-needed public investment. Substantial payment arrears create distortions within the public sector, but are also a burden on private companies. Public finances are suffering from substantial spending inefficiencies, particularly in the health sector, and a poor targeting of social transfers. Planned reforms to improve the quality of public spending have been repeatedly delayed.



The level of official public debt rose from 24% of GDP in 2009 to 35.9% at the end of 2018, while reaching a peak of about 43% in early 2015, to a certain extent resulting from public spending to fight external shocks, such as the financial crisis in 2008 and 2009, and flooding and a drought in 2014. Since then, public debt has remained largely stable in nominal terms, but has declined as a percentage of GDP. The published debt level appears to be relatively low, in particular as a large share of this debt is long-term at rather favourable rates, leading to costs for debt servicing of slightly below 1% of GDP only. However, due to the unclear accounting standards, there is a significant degree of uncertainty related to the 'real' extent of public sector indebtedness. Furthermore, there are significant differences in the indebtedness at lower levels of general government.

In summary, the economy experienced several external shocks during the last decade, but showed a remarkable degree of resilience, partly benefiting from substantial capital inflows from workers abroad, but also from International Financial Institutions. In order to increase the country's endogenous growth potential, long-overdue structural reforms are needed, such as improving the rule of law, improving the business environment and strengthening the efficiency of public sector spending, in particular in the area of a better targeting of social transfers, addressing payment arrears and improving the governance of public enterprises. While macroeconomic stability has been preserved overall, reforms have clearly been implemented too slowly to achieve noticeable progress for the country's citizens. The economic policy mix suffers from an insufficient medium-term orientation, in particular with respect to public investment and education. Overall, the country's macroeconomic policy mix suffers from implementing overdue reforms too slowly and from lacking a sufficient medium-term orientation.

Functioning of product markets

Business environment

Market entry and exit regulations are still lengthy and cumbersome, in particular as the high degree of regional fragmentation leads to many different rules and different interpretations. The legal framework for market entry and exit is largely defined at the lower levels of government, which often results in different regulations and implementation at local level (i.e. in the two entities as well as in Brčko District, and partly also at the level of the 10 cantons in the Federation). There are many similarities among the various regulations and procedures, nevertheless often differences remain, which complicates doing business in different parts of the country. This high degree of fragmentation has a negative effect on the country's business environment, requiring companies to comply with different procedures within different parts of the country. Business registrations in one part of the country are not fully recognised in other parts of the country, requiring a costly multiplication of registration procedures. Furthermore, quality control rules and procedures are different in different parts of the country, which also impedes trade. Business insolvency is regulated at the entity level and there is no countrywide framework. While a law is in place in one entity, the adoption of a more modern bankruptcy law is still in parliamentary procedure in the other entity.

A complex set of different para-fiscal fees, largely levied at cantonal or municipal level, are a further impediment to new company setting up in a different part of the country. The difficult business environment is not only reflected in low rankings in various international surveys, such as the World Bank's 'Doing business' survey, but also is probably a key factor behind the low level of domestic and foreign investment. As a result, the increase in the number of new companies has been rather low, at around 1% annually in 2011-2018. Overall, the procedures required to enter or leave the product market are still numerous, lengthy and have limited regional coverage, creating a significant impediment to market entry and exit.

The institutional and regulatory environment continues to be a crucial weakness with adverse effects on the business environment. Contract enforcement is still a very time consuming procedure. Furthermore, settling commercial disputes remains difficult, partly due to the lack of alternative dispute

resolution methods and a lack of courts specialised on commercial disputes. The backlog in court cases is still substantial. Furthermore, there are frequent disputes on property rights, partly because registration of real estate ownership is limited in some areas. The resource endowment and independence of numerous regulatory and supervisory institutions is insufficient. Overall, weaknesses in the rule of law, including in the functioning of the judiciary, affect the country's market economy.

The size of the informal economy has remained significant. Despite some limited progress in addressing the informal economy, such as improving the degree of registration in the labour market, the informal sector is still substantial, with informal employment estimated to account for nearly one third of total employment. On the one hand, the informal economy is an important source of (unregistered) employment and income. However, on the other hand, this creates an unfair competitive advantage for companies in the grey economy and erodes the base for taxation and social security contributions and for labour rights and labour safety. A high level of informal economy requires rates for taxes and social security contributions to be higher than would be otherwise necessary. This also adds a significant fiscal burden on registered labour, which in turn impedes the creation of formal employment and negatively affects Bosnia and Herzegovina's international competitiveness.

State influence on product markets

State influence on the economy is still high. Despite efforts to reduce state influence, countrywide public spending has remained at a relatively high level. At the same time, the quality of the provided services is low, in particular in the areas of health and education. According to official statistics, public spending accounts for more than 40% of GDP. Sectors providing public services (public administration, defence, compulsory social security, education and human health) generate about 17% of the country's value added and employ according to the annual Labour Force Survey about 18% of the country's labour force. However, when taking into account the value added and the employment in public companies operating in other sectors, such as industry, electricity production and transmission and water treatment, the role of the state in the economy is significantly higher. Given the rather high share of public spending, public procurement plays an important role for the private economy. However, public procurement procedures are complex, prone to corruption and still contain a preference for domestic suppliers, which is incompatible with the *EU acquis*. Payment arrears of the public sector are substantial, in particular in sectors such as public health, creating a substantial burden for private companies, but also a high degree of uncertainty for other public services. Furthermore, arrears are sometimes impeding the financial viability of certain social security services. The costs of supporting public companies and guarantees, which often translate into substantial contingent liabilities, are a heavy burden on public finances and thus the country's taxpayers.

The official level of state aid is low, but indirect state aid could be substantial. Although official state aid data points to a relatively low level of support, a number of public and private companies benefit indirectly from the accumulation of payment arrears of taxes and, in particular social security contributions. Furthermore, state aid control is hindered by the partial alignment of legislation, by the lack of independence and budgetary issues of the authority responsible for its control, as well as by the ethnic vetoes existing in it. The consistent enforcement of state aid rules throughout the country is not assured and the competences of the State Aid council are limited. This leaves room for unfair distortions in the competitive position of some companies in the country

Privatisation and restructuring

The privatisation process is still incomplete. Despite recurring initiatives and significant progress in one entity, similar attempts have been less successful in the other entity. As a result, strategic sectors such as transport and energy (and telecommunication in one entity) are still dominated by poorly managed and often inefficient public enterprises. Restructuring public companies and stimulating competition from the private sector could improve the quality of the services provided and relieve public finances from a

recurring burden. The share of the private sector in the country's value added has remained rather stable over the last 10 years. It creates some 83% of the country's gross value added and generates some 82% of the country's employment. There is still a wide range of administrated prices. However, there is no information available on the weight of administrated prices in the country's consumer basket. The pace of economic restructuring has been slow.

Functioning of financial market

Financial stability

The financial sector has remained stable, but banking sector supervision is hampered by fragmented competences. The sector experienced a short boom before the 2008 financial crisis, but weathered the global financial crisis rather well and has remained largely stable over the last 10 years. Banking sector assets stabilised after a short drop in 2008 and reached nearly 90% of GDP in 2018. The number of banks is high in relation to the market size, although it has fallen from 30 banks in 2009 to 23 in 2018. Foreign banks account for the largest share in the sector's activities: 15 banks out of 23 have a majority foreign ownership and together account for some 84% of the sector's total assets. In some banks, governance and risk management is limited, posing risks in the event of financial stress. There are also two public development banks. One of them is significant in relation to the entities' GDP and the size of the entities' banking sectors. The banking supervision of those state banks is limited.

The banking sector's overall capital adequacy ratio has remained above 15% of risk-weighted assets, which is well above the country's regulatory minimum of 12%. However, there are still pockets of vulnerabilities, as some primarily local banks are confronted with insufficient capital endowment and unfavourable credit portfolios. Regular stress tests done by the Central Bank monitor the sector's shock resilience, but also confirm the vulnerability of some smaller banks. Credit risk indicators for the banking system rose markedly in the aftermath of the 2008 financial crisis but have somewhat improved since then, although most of them are still relatively high. Non-performing loans, which accounted for 9.4% of total loans at the end of 2018, are concentrated in domestically owned banks and are largely a legacy issue. A significant share of the sector's asset portfolio is euro-indexed, which increases the country's exposure to an exchange rate risk and underlines the importance of a stable exchange rate. Interest rate differentials between lending and credit rates dropped from 6 to 4 percentage points, which could also indicate improved competition in the sector. However, in combination with a moderate profitability this relatively high interest rate spread points to remaining inefficiencies in the sector. The Central Bank's analytical capacities are limited and financial sector supervision suffers from fragmented competences and insufficient inter-entity cooperation.

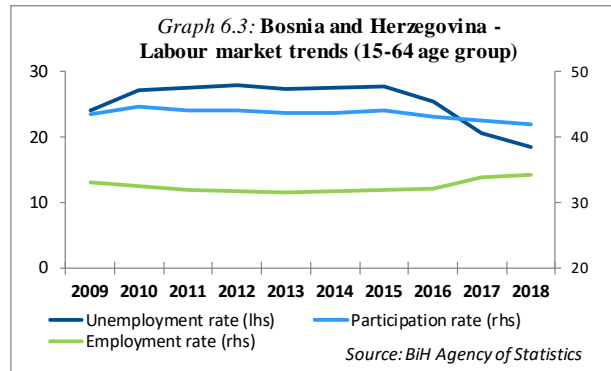
Access to finance

Bank lending to the private sector has gathered pace again. Financial intermediation had been negatively affected in the aftermath of the 2008 financial crisis, but has improved in recent years. While credit growth came to a near standstill in the aftermath of the financial crisis, growth rates have increased to around 6% in recent years. As a result, loans to households and corporations rose from about 50% of GDP in 2009 to some 60% in late 2018. Loans are quite equally distributed between households and the non-financial corporate sector, both in terms of absolute amounts and growth rates, which have tended to be quite similar in both sectors. However, it is still difficult for SMEs and micro enterprises to access finance. The implementation of the new banking laws which were adopted in 2017 should help to preserve the soundness of the banking sector. The size of the non-financial sector and of the capital markets is small.

Functioning of the labour market

Despite recent improvements in increasing employment and reducing unemployment, the overall situation of the country's labour market is still worrying.

Very low labour force participation and employment rates, high unemployment and underemployment appear to be deeply entrenched phenomena in Bosnia and Herzegovina. Unemployment was already relatively high in the last years of the Socialist Federal Republic of Yugoslavia (SFRY), and rose further during the war. It has remained high since the war, as many previously public companies were no longer viable and alternative employment opportunities were scarce. As a result, unemployment is very high, in particular when using administrative data, which report that at the end of 2018, the share of registered unemployed was 35% of the labour force, compared to 42.7% at the end of 2009. However, the administrative rate includes a significant number of people working either in the informal sector or not looking for work at all, but who are registered mainly for social security coverage. According to the annual Labour Force Survey, the unemployment rate rose from 24.1% in April 2009 to 28% in April 2012 but fell to 18.4% in April 2018. Youth unemployment reached a peak of 63.1% in 2012, compared to 47.5% in 2009, but has slightly declined since then, dropping to 38.8% in 2018. According to the survey, long-term unemployment is high: in 2018, a total of 82.3% of all unemployed (15+ years old) were unemployed for at least 12 months. This level is similar to 10 years ago, when this share was 84.1%. At the same time, the activity ratio is low: in April 2018, only 54.2% of the working-age population were actively looking for work.



This high and persistent unemployment rate points to significant weaknesses in the functioning of the country's labour market. In the last few years there have been some improvements in recording so-far-unrecorded employment and in increasing the employment of vulnerable groups through active labour market measures. However, those active measures rely strongly on employment subsidies, which are usually less effective in addressing structural unemployment. Labour legislation has also been modernised. The resource endowment of the public employment services and its cooperation with the social service centres is insufficient. Furthermore, there are serious shortcomings in the education sector, leading to a substantial mismatch between the education provided and labour market needs. The ability of the private sector to create new employment is very limited. The significant differences between registered and survey-based labour market data signal substantial weaknesses in labour market statistics.

Bosnia and Herzegovina is at an early stage of establishing a functioning market economy.

Special attention needs to be paid to speeding up and improve the country's decision-making procedures, to improving the business environment as well as the efficiency and transparency of the public sector, in particular of public companies.

In particular, the country should address the impediments to the proper functioning of market mechanisms, such as a weak rule of law, substantial red tape, corruption, lengthy and overly complex administrative procedures and a high fragmentation of the country's internal market. Those structural weaknesses have a negative impact on the labour market, reflected in high unemployment and a very low participation rate, which constrains both actual and potential growth of the economy.

In order to improve the functioning of the market economy in the coming year, Bosnia and Herzegovina

should in particular:

- simplify and harmonise business registration and licensing procedures between entities to improve the business environment and create a single economic space;
- increase transparency of the public sector, by creating publicly available registers of public enterprises and by providing timely data on public sector employment, public sector payment arrears and para-fiscal charges;
- adopt the General Government Sectorisation in line with ESA 2010 and publish complete and consistent country-wide general government data in a timely manner;
- reduce the tax wedge, especially for low-income workers, and disincentives to work in order to support formal employment.

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

The ability to fulfil this criterion depends on the existence of a market economy and a stable macroeconomic framework which allows economic agents to take decisions in a climate of predictability. It also requires a sufficient amount of human and physical assets. Enterprises need to invest to improve their efficiency and they need to innovate in order to adjust to a globalised and highly competitive external environment. The more an economy is integrated with the Union before accession, the better it will be able to assume the obligations of membership.

Education and innovation

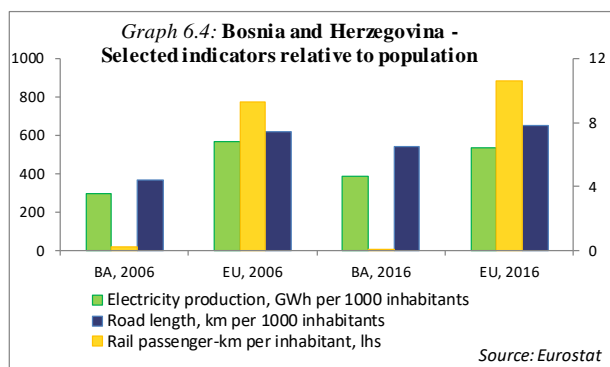
Bosnia and Herzegovina's level of human capital is hampered by poor educational outcomes and also suffers from a substantial brain drain. The country's education system is very complex and highly fragmented, as legal competences are largely allocated at entity and cantonal level. This results in a lack of common standards for various levels of education, as well as in teacher training and performance evaluation. Teaching curricula are often outdated and not sufficiently aligned with the country's needs. This leads to wide skills mismatches, which is a major impediment, preventing graduates from entering the labour market. The number of pupils enrolling in pre-school education is slightly increasing, but very low compared with the EU average (in 2017/18 approximately 18% compared with 95,3% in EU for children from the age of 4 until the start of the compulsory primary education). In primary and secondary education the number of enrolled children has started to decline in recent years. To some extent, this reflects demographic dynamics, such as declining net birth rates but also emigration of young families. The share of those with high educational attainment stood at 10% in 2018, compared to 7% in 2009. Data on country-level public sector spending on education is currently not available. In 2018, Bosnia and Herzegovina participated for the first time in the OECD's PISA study. The results are expected by end-2019 only. The country's illiteracy rate stood at 2.8% of the age group 10 years and older, according to the 2013 population census. This is one of the highest in the region, largely as a result of a relatively high illiteracy rate among women (of 4.8%).

Physical capital and quality of infrastructure

The physical capital stock suffers from decades of underinvestment. Public and private investment has remained low over the last 10 years, with spending on private gross fixed capital investment dropping from 19.7% in 2009 to around 17% during the last three years. This drop in private investment probably reflects the poor business environment and the low degree of certainty caused by frequent political stalemates. Public investment accounted for only about 3% of GDP on average in 2009-2018,

significantly less than in comparable catching-up economies. However, in 2018 the authorities agreed to increase excise taxes on fuel, which helped to unlock official foreign financing, primarily for infrastructure projects. Given the country's need to modernise its infrastructure, these investment rates appear low. This is largely the result of a public spending policy, which prioritises payments for public sector employment and for transfers, thus leading to frequent delays in infrastructure investment. This approach is delaying efforts to improve the country's growth potential and labour productivity, which in turn hampers the country's efforts to improve income levels and living standards. The country's level of digitalisation is low when compared to peer countries. This applies in general to the access to and the use of information and communication technologies (ICT), but also to the lack of a national broadband strategy. E-Signatures are still not available countrywide.

Annual FDI inflows remained limited during the last 10 years, accounting for some 2.25% of GDP on average. However, during most of the period, FDI inflows have remained limited, and recent inflows have increasingly consisted of reinvested earnings. Nearly two thirds of the country's stock in FDI originates from EU countries and is concentrated in manufacturing, the financial sector, retail and tourism.



Transport and energy infrastructure is fragmented and outdated. Compared to its peers, the country performs very poorly in terms of an adequate infrastructure for transport and energy, which impedes the country's growth potential and competitiveness. This weakness reflects the country's short-term oriented approach to economic governance, which prioritises maintaining the status quo over forward-looking policies. As a result, much-needed investment in transport and energy

infrastructure is frequently delayed as available funds are used to finance public sector employment or to maintain an inefficient social security system. Furthermore, the absence of a single or sufficiently harmonised regulatory framework and inadequate cooperation and coordination among the various stakeholders mean that planned investment projects are often delayed. The markets for energy and transport remain fragmented and are frequently dominated by key incumbent companies. The natural gas sector is another example where fragmented regulation (at entity level) hinders the development of an adequate countrywide legal framework and a common market, which impedes competition.

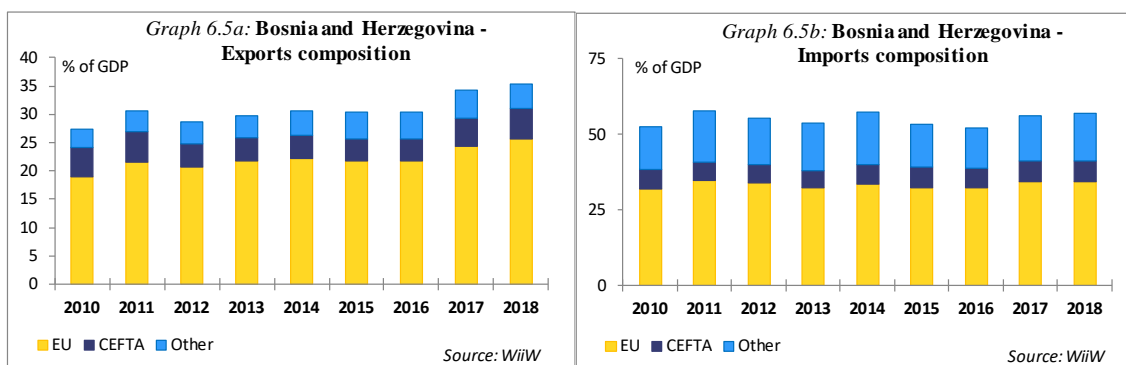
Sectoral and enterprise structures

Structural change in the economy has remained very limited. Changes to the structure of production, employment and company composition are a sign that the economy is adapting to a changing environment. In Bosnia and Herzegovina, structural change has been quite limited, which probably has to do with the governments' approach of maintaining the status quo. When looking at the production side, trade and manufacturing have been key sectors gaining importance, while the share of value generated in the public sector has declined. The picture is similar for employment: there have been relative employment gains in the manufacturing and services sectors, while the public sector has lost slightly. Concerning the composition of companies, there seems to have been a significant increase in medium-sized companies, employing between 50-249 employees, which is a good sign. The majority of new companies were created in the group of micro companies (0-9 employees), which were often located in the lower value added area of trading companies. However, the lack of information on the informal sector might mask important changes, in particular in micro companies. Overall, the company structure is still dominated by small and micro businesses, with companies of less than 50 employees accounting for 95%

of all companies. Their access to bank lending remains difficult. Support schemes are in place for small and medium-sized enterprises, but provides services are very limited, scattered and depend on donor funding.

Economic integration with the EU and price competitiveness

Trade integration with the EU increased markedly, but also trade with neighbouring non-EU countries has deepened. During 2009-2018, trade integration with the EU increased, with the share of exports to the EU-27 (i.e. before Croatia's accession in 2013) increasing by 6.6 percentage points, from 53.5% in 2009 to 60.1% in 2018. When looking at EU-28, i.e. including Croatia, Bosnia and Herzegovina's exports to the EU rose by 2.3 percentage points during the last 10 years, from 70.6% of total exports in 2009 to 72.9% in 2018. In recent years, trade with neighbouring non-EU countries such as Serbia and Turkey has also increased markedly. However, the country's openness to trade is still relatively low for its limited economic size, with total trade in GDP accounting for 94% of GDP in 2018, however, compared to some 80% a decade ago. The range of export commodities is not very sophisticated. Non-tariff barriers to trade with the EU, such as required sanitary and phytosanitary standards, remain a problem, despite some recent success in complying with some of the standards required to export to EU markets. Integration of financial and capital markets with the EU is very limited.



Bosnia and Herzegovina is at an early stage in achieving the capacity to cope with competitive pressure and market forces within the Union.

In the medium-term, special attention needs to be paid to the low quality of education and its insufficient orientation towards labour market needs, the quality of physical capital, such as the insufficient transport and energy infrastructure, and the slow adjustment of the country's economic structure.

In order to improve competitiveness and long-term growth in the coming year, Bosnia and Herzegovina should in particular:

- take steps to modernise teaching curricula and undertake a review of secondary and higher education enrolment policies in order to improve their links to the current and prospective needs of the domestic labour market;
- adopt and implement consistent medium-term public investment strategies and focus fiscal policies on investment and education to increase the country's growth potential;
- support structural change by facilitating the establishment of new companies.

6.3. GENERAL EVALUATION

Bosnia and Herzegovina is still at an early stage of establishing a functioning market economy and of becoming competitive within the common market.

Economic governance is impeded by a high degree of politicisation and a lack of cooperation among key stakeholders. This leads to frequent political stalemates and lengthy delays in the political decision-making process. Furthermore, economic governance is prioritising maintaining the status quo, which further slows down the formulation and implementation of overdue structural reforms. As a result, the role of the state is still disproportionate, absorbing substantial resources to fund generous public sector employment, inefficient public enterprises and an inefficient social security system. The frequent political stalemates and the resulting low predictability for investors have a negative bearing on the business environment. This is further hampered by a poor rule of law, substantial red tape, corruption and lengthy and complex administrative procedures, partly a result of the high degree of fragmentation of the country's internal market. As a result of this poor business environment and of weaknesses in the country's education system, structural unemployment is worryingly high, in particular among young people and vulnerable cohorts. Furthermore, the informal economy remains significant, creating unfair competition and leading to a higher tax burden than otherwise necessary.

Education is of low quality and the country suffers from a skills mismatch, resulting from outdated teaching curricula and insufficient resource allocations. Also, in the area of research and development, public spending is very low, accounting to only 0.3% of GDP, according to officially provided data, which is far from the 3% EU target for 2020. The quality of the country's physical capital suffers from chronic underinvestment and inefficient implementation. The infrastructure for transport and energy is insufficiently developed. The speed of structural adjustment is slow, partly reflecting the difficulties and complexities of establishing and maintaining new enterprises in a highly fragmented and politicised economy, although recently there has been some diversification in the country's regional trade structure.

6.4. CONCLUSIONS

As regards the economic criteria, Bosnia and Herzegovina has achieved a certain degree of macroeconomic stability. However, to move towards becoming a functioning market economy, which is a criteria set by the 1993 Copenhagen European Council, Bosnia and Herzegovina needs to pay special attention to speeding up its decision-making procedures and improving the business environment as well as the efficiency and transparency of the public sector, in particular of public enterprises. The country should address the impediments to the proper functioning of market mechanisms, such as a weak rule of law, substantial red tape, corruption, lengthy and overly complex administrative procedures and a high fragmentation of the country's internal market. In order to enable it to cope over the medium term with competitive pressure and market forces within the Union, Bosnia and Herzegovina needs to pay special attention to the low quality of education and its insufficient orientation towards labour market needs, the quality of the physical capital, such as the insufficient development of transport and energy infrastructure and the slow adjustment of the country's economic structure.

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.

Economic governance has become even more central in the enlargement process in recent years. The Commission's monitoring takes place in two processes: the Economic Reform Programme exercise and the assessment (see below) of compliance with the economic criteria for accession. Every year, each enlargement country prepares an economic reform programme (ERP), which sets out a medium-term macro-fiscal policy framework and a structural reform agenda aimed at ensuring competitiveness and inclusive growth. The ERPs are the basis for country-specific policy guidance jointly adopted by the EU and the Western Balkans and Turkey at ministerial level in May each year.

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo has made **some progress** and is at an **early stage** of developing a functioning market economy. Economic growth was robust in 2018, but the very challenging labour market situation remains a concern. Labour market participation and employment rates did not improve as compared with 2017. The government adhered to the fiscal rule, but spending pressures relating to social benefits for specific groups of the population and public employees' wages pose risks to public finances and hinder private sector development. The business environment improved somewhat, but persistent challenges remain, including the widespread informal economy, a slow and inefficient judiciary, high prevalence of corruption and overall weak rule of law. Despite strong growth of services exports, economic diversification has advanced slowly.

In order to improve the functioning of the market economy, Kosovo should in particular:

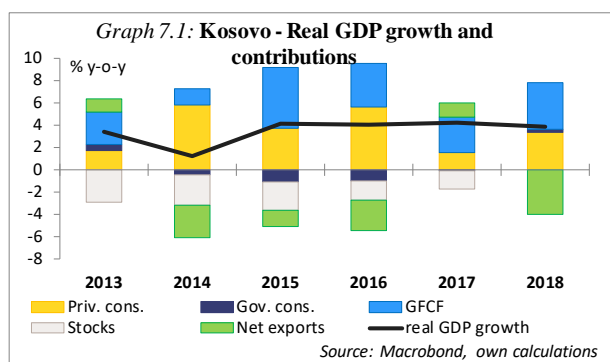
- ensure that the 2020 budget complies with existing fiscal rules, in particular the wage bill rule;
- improve financial oversight and accountability of publicly owned enterprises and advancing their privatisation;
- improve further the access to finance for SMEs by addressing the underlying legal and institutional factors;
- develop active measures for increasing female labour market participation and employment.

Economic governance

Kosovo's rules-based policy framework supports fiscal sustainability. However, new government initiatives pose risks to macroeconomic stability. Fiscal projections in the 2019-2021 medium-term expenditure framework (MTEF) and in the 2019 budget are in line with the fiscal rule. At the same time, the government is engaged in fiscal initiatives, such as recently adopted the Law on salaries for public employees and social transfers for specific groups that create significant fiscal risks with a potentially negative impact on macroeconomic stability. The policy guidance jointly agreed at the May 2018 Economic and Financial Dialogue between the EU and the Western Balkans and Turkey has been partially implemented. On the other hand, the recent introduction of 100% tariffs for all goods imports originating in Serbia and Bosnia and Herzegovina represents a direct violation of the Central European Free Trade Agreement (CEFTA).

Macroeconomic stability

Economic activity has been growing steadily since 2015, but it is constrained by a narrow production base and significant under-utilisation of labour. Based on the aggregate of four quarters,



real GDP growth reached 3.9%.⁽⁷⁾ In recent years, the economy has been driven by public investment in infrastructure and private consumption, the latter financed by large remittances from abroad and robust wage and credit growth. The exceptional (18.8%) export growth in 2017, supported by goods and services, slowed to 13.9% in 2018 due to a temporary fall in base metal exports. Economic diversification is proceeding slowly. Merchandise exports remain dominated by base metals and mineral

products, which still account for around 48% of total exports. Services exports continued to grow, mainly linked to tourism spending by the diaspora.

	2010-15 average	2016	2017	2018 [#]
GDP per capita (% of EU-28 in PPS)	24.4	26.0	26.3	:
Real GDP growth	3.2	4.1	4.2	3.9
Economic activity rate of the population aged 15-64 (%) , total	39.2*	38.7	42.8	40.9
<i>female</i>	19.6	18.6	20.0	18.4
<i>male</i>	58.5	58.5	65.3	63.9
Unemployment rate (%) , total	32.3*	27.9	30.5	29.6
<i>female</i>	39.3	31.8	36.6	33.4
<i>male</i>	30.0	26.2	28.7	28.5
Employment (annual growth %)	-0.3**	11.1	6.4	-3.4
Nominal wages (annual growth %)	5.8**	1.8	1.7	:
Consumer price index (annual growth %)	2.5	0.3	1.5	1.1
Exchange rate against EUR	1.0	1.0	1.0	1.0
Current account balance (% of GDP)	-8.2	-8.3	-6.8	-8.1
Net foreign direct investment, FDI (% of GDP)	5.7	3.6	3.9	3.3
General government balance (% of GDP)	-2.4	-1.2	-1.3	-2.8
General government debt (% of GDP)	8.7	14.3	15.5	16.2

Source: Kosovo statistics, World Bank and IMF

Notes: # the latest available or estimate, *average of 2012-2015, **average of 2013-2015

(7) The quarter-based annual estimate for 2017 is 3.7%.

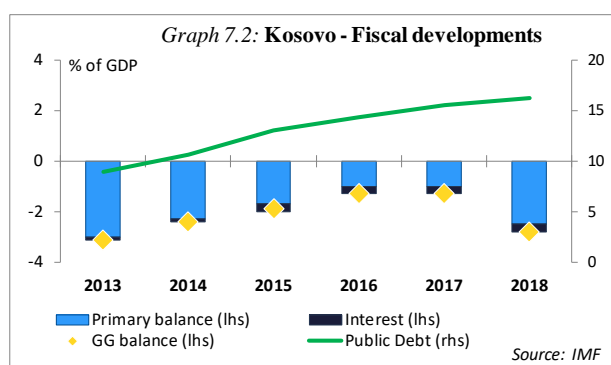
Kosovo's per capita GDP is the lowest in the region. It stood at EUR 3,566 in nominal terms in 2017, which is about 26.3% of the EU average ⁽⁸⁾ (the regional average is EUR 4,853). However, in terms of average gross wages (EUR 519 in 2016), Kosovo ranks second in the region (after Montenegro), which suggests weak competitiveness in an international context. Inequalities remain widespread due to a large informal sector, high inactivity rates and high wages in the public sector.

The traditionally large current account deficit persisted in 2018. The goods trade deficit increased to 43% of GDP, from 38.4% in 2017, pushing up the current-account deficit to 8.1%. This was driven by strong growth in imports (13.6% year-over-year (y-o-y)) and a decline in goods exports (7% y-o-y). The widening trade deficit was partly mitigated by positive balances of services and remittances (1.4% and 12% of GDP, respectively).

On the financing side, net foreign direct investment (FDI) fell by 16% y-o-y in 2018. The total FDI inflow was 3.3% of GDP, covering less than a half of the current-account deficit. The drop in FDI was due to higher repatriation of foreign firms' profits for debt repayments, which reduced the scope for reinvestment of earnings. Reserve assets continued to decline, from 4.8 months of imports of goods and services in 2015 to 3.5 months in 2018. ⁽⁹⁾

Price developments are driven mainly by import prices for food and energy. Average annual inflation reached 1.1% in 2018, as price rises recovered gradually over the year, from -0.2% y-o-y in January to 2.9% y-o-y in December. The key driver was food prices, which were on the rise from July and hit 5.5% y-o-y in December following the introduction of the 100% tariffs on goods imported from Serbia and Bosnia and Herzegovina.

Despite the lack of progress in revising the war veterans' benefits scheme, fiscal stability was preserved in 2018, but the budget composition is not sufficiently conducive to growth. The 2018 budget deficit is estimated at 1% of GDP, well within the fiscal rule ceiling of 2%, while the overall fiscal deficit stood at 2.8% of GDP. Annual growth of budget revenue was 5.3%, while budget expenditure expanded by 11.2%. Higher social spending, caused by the failure to reform untargeted and costly war veterans' benefits, was partly offset by the under-execution of the capital budget. Spending on subsidies and transfers has increased rapidly in recent years, reaching nearly 39% of current expenditure in the draft 2019 budget, while the composition of benefits shifted away from poverty and inequality-focused transfers towards benefits for particular categories of the population.



Apart from the fiscal impact, this has negative repercussions on labour market participation and competitiveness. By regional standards, Kosovo's public debt remained relatively low (16.2% of GDP) in 2018, ⁽¹⁰⁾ but it has risen steadily from nearly 10.6% of GDP in 2014.

Fiscal governance has made some progress with respect to the credibility of the MTEF and budgetary projections. The collection of revenue has performed better than the execution of expenditure, which reflects a deeply entrenched problem of overspending for social benefits and over-optimistic planning of

⁽⁸⁾ World Bank data.

⁽⁹⁾ IMF data.

⁽¹⁰⁾ The simple average of public debt in the six Western Balkan economies was estimated at 47.9% of GDP in 2018. Kosovo's public debt does not include its share of the former Yugoslavia's debt, which the IMF has recently reclassified as contingent liability.

capital expenditure. The macroeconomic forecast underlying the 2019 budget is still considerably higher than the projections of other organisations. ⁽¹⁾ Moreover, quarterly GDP figures do not match annual data.

Given Kosovo's unilateral euroisation, sound fiscal and financial policies are essential for maintaining macroeconomic stability. The existing fiscal rule, which provides the main anchor for fiscal sustainability, was fully respected in 2018. The planned fiscal expansion in the 2019 budget and likely additional spending, resulting from the recently adopted Law on salaries for public employees and from pension supplements for teachers, raise concerns as to the sustainability of public finances. Further downside risks stem from the currently discussed early retirement scheme for the police and maternity benefits for unemployed and self-employed women.

Functioning of product markets

Business environment

The number of newly registered and terminated firms is in line with long-term trends. In 2017, the difference between new (9,223) and terminated firms (1,623) stood at 7,600, back in line with the historical trend after an exceptional performance in 2016, when the gap widened to 8 048 due to higher numbers on both sides.

Kosovo made some progress in improving the business environment. While it made some improvements as regards registering a business and getting a loan, its overall ranking in the World Bank's *Doing Business* report fell to 44th in 2018 from 40th a year earlier. Legislative changes contributed to a more favourable business environment. The new Law on business organisations (adopted in May 2018) improved the provisions on the registration of business organisations and corporate governance, and strengthened the rights of minority shareholders. A revamped electronic platform should speed up business registrations. The new Law on accounting, audit and financial reporting (adopted in April 2018) streamlines reporting requirements for companies and defines the interest of public entities in line with the *acquis*.

Despite progress in adopting new legislation to improve the business environment, the private sector faces a number of challenges related to cumbersome administrative procedures, informality and corruption. With a large number of inspectorates, poor coordination of procedures and legal contradictions, the inspections process often remains a barrier to doing business in Kosovo. A new Law on inspections has been prepared and its adoption and implementation would help to address these concerns. Similarly, the large number of licences and permits still poses an administrative burden for businesses. The central register for permits and licences is still being updated. Slow and inconsistent adjudication in economic disputes remains a challenge. In 2018, the Kosovo Investment and Enterprise Support Agency (KIESA) continued to operate with limited resources and without permanent leadership. A further strengthening of KIESA, particularly by reinforcing after-care services for foreign investors and operationalising the high-level advisory board for the promotion of foreign investment, would be a key step towards enhancing prospects for investments and exports.

The large informal sector (estimated at around 30% of GDP) creates unfair competition and weakens labour rights. In May 2019, Kosovo adopted a revised strategy and action plan for fighting the informal economy including measurable indicators to monitor progress in this area.

State influence on product markets

⁽¹⁾ The 2019 budget assumes real GDP growth of 4.7%, while the IMF and Central Bank of Kosovo forecast 4.2%.

Kosovo's state aid policy is not underpinned by a coherent approach. The government lacks the compatibility assessment of state aid as well as a comprehensive strategy and cost-benefit evaluations for aid and subsidies granted. Most publicly owned enterprises remain reliant on public funding from the budget. Kosovo has yet to meet its Stabilisation and Association Agreement (SAA) obligations on state aid schemes and alignment with EU rules. Financial support for the economic zones and industrial parks continued without a clear plan or a transparent impact or gap analysis, raising concerns on state aid compatibility. The impact of the Law on strategic investment, adopted in 2017, did not visibly affect investment in 2018, although 11 investors applied, with investment plans for a total of EUR 1.8 billion.

Privatisation and restructuring

Progress in privatisation remained slow. ⁽¹²⁾ Publicly owned enterprises remain inefficient and lack transparency in their financial reporting and recruitment. After the completion of the board of directors in mid-2018, the Privatisation Agency of Kosovo conducted six asset sales from a total of 400 which are in tendering process. Twelve state-owned enterprises' assets were put into liquidation in 2018, which is very low given the total number of 511 enterprises under the liquidation procedure in 2005-2018. The decision to freeze the privatisation of socially owned land has contributed to delays in the privatisation process. The socially owned Trepça mining complex was officially transformed and registered into a joint stock company in March 2019. Further steps to operationalise this transformation will require coordination among all affected stakeholders, with the overall aim to revitalise the enterprise.

Functioning of the financial market

Financial stability

The financial sector remained stable, with adequate capitalisation and substantial liquidity buffers. Profitability remained high, with return on average equity (as of October 2018) standing at 18.8% for the banking sector, 18.7% for micro-financial institutions and 17% for insurance enterprises. The predominantly foreign-owned banking sector, which accounts for 64.8% of financial system assets, remained well-capitalised and liquid, with non-performing loans standing at 2.7% of total loans at the end of 2018 (the lowest level in the region). The ratio of banks' regulatory capital to risk-weighted assets stood at 16.1% in October 2018, well above the regulatory minimum of 12%. Banks continued to be predominantly financed by deposits, but the loan-to-deposit ratio rose to 83.9% in October 2018 from 79% a year earlier, as the growth of loans outpaced deposit growth. Despite the increasing activity, insurance and micro-finance companies still do not account for more than 7% of financial system assets, but the headline financial soundness indicators are at satisfactory levels.⁽¹³⁾

Access to finance

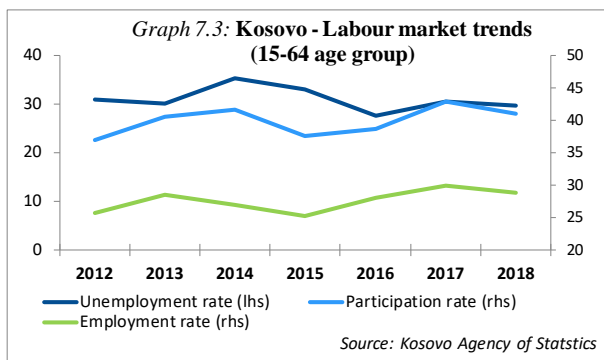
Lending has continued to expand, but financial intermediation is still at low levels. Bank lending expanded by 11.6% in January-October from 2017, facilitated by low interest rates, eased credit standards, guarantees extended by the Credit Guarantee Fund for lending to SMEs, and strengthened contract enforcement. Lending to firms (11.8%) and households (11.3%) registered similar rates of growth. The average interest rate spread declined to 5.2 percentage points (pps) in October 2018, from 5.8 pps the previous year, pointing to strengthening competition for lending opportunities. Credit penetration, at around 40% of GDP, is low by Western Balkan standards, and channelling savings, including remittances, through the formal financial system into productive investment remains a challenge.

⁽¹²⁾ According to World Bank estimates, the public sector in Kosovo still accounts for around a quarter of gross value added (GVA) and employment.

⁽¹³⁾ While the headline figure presents a satisfactory picture, there are a number of issues in the insurance sector, as some firms are still in the red and three of them are under-capitalised.

Functioning of the labour market

Despite robust economic growth since 2015, labour market conditions remain difficult. According to the labour force survey (LFS), labour force participation fell to 40.9% in the last quarter of 2018, from 42.8% a year earlier. The participation rate of women stood at 18.4%, with more than a third of economically active women (33.4%) unemployed. The overall employment rate stood at 28.8%, as compared with 29.8% a year earlier. The wide gap between male and female employment rates (45.3% and 12.3% respectively) persisted.



Unemployment slightly fell to 29.6% from 30.5%. Persistently high youth unemployment (55.4%) points to a misalignment between education outcomes and labour market needs. Brain drain, especially of educated young people, also poses a medium/long-term economic challenge. Active labour market policies, pre-qualification schemes and vocational training programmes remain inadequate.

The use of social benefits for specific groups of the population do not focus on poverty reduction and creates disincentives to work. The untargeted war veterans' transfers not only undermine the soundness and fairness of the social benefits system, but also risk creating a snowball effect whereby other specific groups request similarly generous allowances, e.g. the recently adopted pension supplements for teachers. The relatively high salaries in the public sector, in particular in publicly owned enterprises, negatively affect the attractiveness of private-sector employment and exacerbate the skills gap. The lack of childcare facilities hinders female employment.

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

Kosovo has made **some progress** and is at an **early stage** in terms of capacity to cope with competitive pressure and market forces in the EU. Kosovo made some progress in improving road infrastructure, but there are large gaps in railway and energy infrastructure. Little progress was made in securing a stable energy supply and losses in the electricity sector remain very high. Kosovo made some progress as regards the digitalisation of the economy. Little progress was made on improving the quality of education and addressing skills gaps in the labour market. Structural changes are emerging only slowly and the economy remains highly reliant on the domestic trade sector. Export growth is driven mainly by service exports to the diaspora, while the lack of product diversification hinders the growth of goods exports.

In order to improve competitiveness and long-term growth, Kosovo should in particular:

- increase the provision of vocational education and training for professions in demand;
- improve energy efficiency incentives for firms and households;
- make the support schemes for renewable energy projects more cost efficient, by introducing competitive bidding for renewable support;
- ensure the implementation of the new Strategy and Action Plan 2019-2023 to fight the informal economy in accordance with the prescribed timetable.

Education and innovation

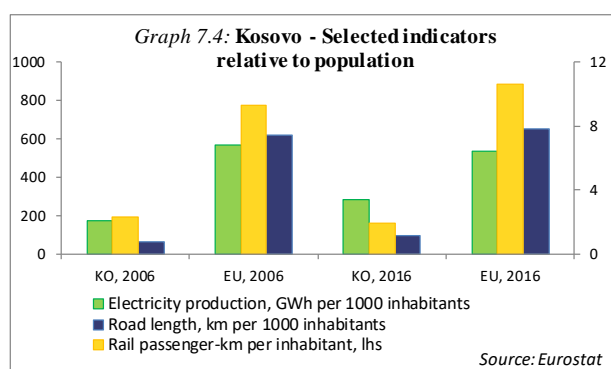
The education system is not responding sufficiently to labour market needs. While Kosovo's public spending on education (4.7% of GDP in 2017) is broadly in line with middle-income countries with similar age profiles, spending per student in primary and secondary education is relatively low due to the large proportion of students (double the EU average) and is dominated by the wage bill for teachers. The enrolment rates in primary (96%) and secondary (88.1%) education are high, but low PISA ⁽¹⁴⁾ scores and relatively high unemployment among tertiary education graduates (19.2% in Q2-2018) compared to the EU point to the poor quality and relevance of education. The work on vocational education reform is still at an early stage, focusing mainly on analysing the current situation in vocational education training (VET) schools.

Spending on research remains virtually non-existent, currently representing only 0.1% of GDP. A new Ministry of Innovation was established in 2018 and EUR 1.1 million was allocated for specific labs and equipment at two regional innovation centres.

Physical capital and quality of infrastructure

Kosovo made progress in public road infrastructure investments. This includes the highway to Peja / Peć, the ongoing construction of a section of route 6 and preparatory work on route 7. Nevertheless, the transport system still faces a number of challenges, such as inadequate road maintenance, poor status of railways and weak administrative capacity of regulatory institutions.

Unreliable energy supply remains a key bottleneck for Kosovo's economic development. The government has taken steps to join the Albanian Power Exchange, but the new 400 kV transmission line and load frequency control with Albania are not operational, because of disagreements between Kosovo and Serbia on the implementation of the connection agreement reached in the EU-facilitated dialogue. Kosovo has no domestic gas infrastructure, but a pre-feasibility study on connecting Kosovo and Albania



to the trans-Adriatic pipeline (TAP) project has been completed. The government has concluded a commercial agreement with the bidder on the construction of the Kosova e Re 500 MW lignite power plant, which is due to start in 2019. Following the World Bank's withdrawal from the partial loan guarantee, financing arrangements for the estimated EUR 1 billion plus project are still to be settled. It may have a major impact on public finances, tariffs and the environment and this must be carefully reassessed.

Boosting energy efficiency and diversification from coal remain important policy considerations. Despite investment in energy network infrastructure (EUR 15 million), distribution losses remain high even by regional standards, reaching nearly 24% in the first half of 2018. The energy efficiency Law (adopted in 2018) established an Energy Efficiency Fund, which will support the relevant measures in public buildings. No progress was made on further energy efficiency measures, such as price deregulation for the household sector. Electricity produced from renewables accounts for 3.2% of total production.

The digitalisation of the economy is gradually advancing. Kosovo had achieved the mid-term targets in the 2013-2020 digital agenda for Kosovo by mid-2018, as penetration of fixed broadband internet

⁽¹⁴⁾ OECD programme for international student assessment.

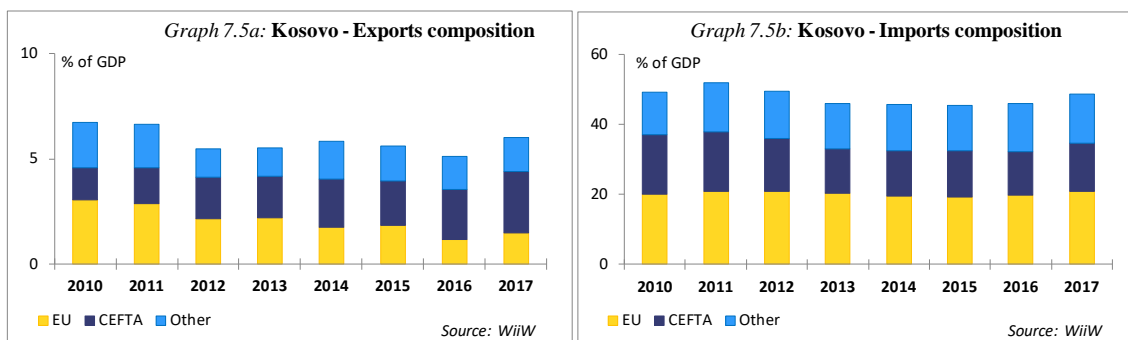
reached 91% and the number of mobile phone users stood at 103% of the population.

Sectoral and enterprise structure

The services sector continues to dominate the economy in terms of GDP and employment. Wholesale and retail trade accounts for the biggest group of registered enterprises (23.5% of the total), followed by manufacturing (9.7%), accommodation (9.6%) and construction (8.5%). The sectoral structure of gross value added (GVA) shows a steady decline in the share of agriculture, from 14% in 2009 to 9% in 2017, followed by shrinking contributions from public administration and real-estate activities (down from around 9% each in 2014 to around 7.5% in 2017). At the same time, the share of construction increased from its long-term average of 6.5% to 8% in 2017. The shares of wholesale and retail trades and industry, including mining, remain around their long-term averages (over 12% each), accounting together for nearly a quarter of GVA since 2012. These sectors also employed the largest (quite stable) proportions of workers (over 14% each over the last four years). The proportion of workers in construction rose rapidly from 9.5% in 2012 to nearly 13.9% in 2017. Despite agriculture’s shrinking contribution to GVA, employment in the sector resurged from 2.3% in 2015 to 4.4% in 2017, suggesting a shift to formal jobs, as this sector has a high rate of informal employment.

Due to the dominance of micro-enterprises, Kosovo’s private sector cannot benefit from economies of scale. Although SMEs represent over 99% of registered enterprises, almost all of them are micro-firms employing 1-9 employees, while the proportion of larger firms (employing 10-249 workers) is only 1%. The entry into force of the Competitiveness of Small and Medium-Sized Enterprises (COSME) Agreement in 2018 should allow the effective use of the EU programme to support SMEs.

Economic integration with the EU and price competitiveness



The EU is Kosovo’s largest trading partner, with 41.3% of overall merchandise trade in 2018. It is followed by the CEFTA parties, with 29% of total trade. The CEFTA parties account for nearly 48% of Kosovo’s merchandise exports and 30% go to the EU. On the import side, the EU’s share is over 40%, followed by 28% from the CEFTA parties. The recent imposition of 100% import tariffs for goods originating in Serbia and BiH is in violation of CEFTA and hampers the development of a Western Balkans regional economic area (REA). The EU has repeatedly called on Kosovo to revoke this economically counterproductive measure.

The EU remains the main investor in Kosovo. Its share stood at 36% of net FDI stock in the third quarter of 2018. Germany and Switzerland (two countries with large Kosovar diasporas) accounted for 11% each, while a further 13% originated in Turkey. In terms of FDI flows the share of the EU was at 47% of total inflow in 2018, followed by 30% from Switzerland. ⁽¹⁵⁾

⁽¹⁵⁾ Data for January-October.

Overall trade openness increased to 79% of GDP in 2017 from 72% in 2013. Exports of goods and services increased from 22% to 27% of GDP due to a significant contribution from service exports. These remain dominated by travel services to the diaspora, but IT and other business services increased, reaching almost 10% of total service exports in 2018. Most of Kosovo's goods exports still consist of basic raw materials and mineral products, reflecting limited diversification of the production sector.

7.3. CONCLUSIONS

As regards the economic criteria, Kosovo is at an early stage and has made some progress in developing a functioning market economy. Economic growth was robust but the very challenging labour market situation remains a concern. The government adhered to the fiscal rules, but spending pressures relating to social benefits for specific groups of the population and public employees' wages pose risks to public finances and hinder private sector development. The business environment improved somewhat, but persistent challenges remain, including the widespread informal economy, a slow and inefficient judiciary, high prevalence of corruption and overall weak rule of law institutions. Despite strong growth of services exports, economic diversification has advanced slowly.

Kosovo is at an early stage and has made some progress regarding its capacity to cope with competitive pressure and market forces in the EU. Kosovo made some progress in improving roads, but there are large gaps in the railway and energy infrastructure. Little progress was made in securing a stable energy supply and losses in the electricity sector remain very high. Kosovo made some progress as regards the digitalisation of the economy. Little progress was made on improving the quality of education and addressing skills gaps in the labour market. Structural changes are emerging only slowly and the economy remains highly reliant on the domestic trade sector. Export growth is driven mainly by service exports to the diaspora, while the lack of product diversification hinders the growth of goods exports.

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