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Progress towards meeting the economic criteria for EU accession

The EU Commission's 2016 assessments

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EUROPEAN ECONOMY

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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 2016 European Commission's country reports for the seven enlargement countries Albania, Bosnia and Herzegovina, the former Yugoslav Republic of Macedonia, Kosovo^(*), Montenegro, Serbia and Turkey. The reports assess progress achieved over the last 12 months in each of the countries, embedded in a broader assessment of trends over a 3 to 5 year horizon, with a view to advance necessary political and economic reforms as well as legal transformation in line with the EU criteria. The European Commission adopted the country reports on 9 November 2016 as part of its 2016 Enlargement Package.

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

The purpose of this Institutional Paper is to facilitate the work of those scholars, researchers and analysts of the enlargement process, who are mainly interested in the economic aspects. As such, it represents only a part of the overall progress made by the enlargement countries towards meeting the accession criteria. A proper full-fledged assessment of progress made under all examined aspects can be found in the 2016 reports, i.e. the Commission staff working documents for each of the countries.

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

The methodology of the Progress Reports

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

The criteria are:

- the political criteria - stability of institutions guaranteeing democracy, the rule of law, human rights, and respect for and protection of minorities;
- the economic criteria - the existence of a functioning market economy as well as the capacity to cope with competitive pressure and market forces within the Union;
- the institutional criteria - the ability to take on the obligations of membership including adherence to the aims of political, economic and monetary union, which includes the whole range of policies and measures that constitute the *acquis* of the Union. Candidate countries must adopt, implement and enforce the *acquis*. This requires the administrative capacity to transpose European Community legislation into national legislation, to implement it and to effectively enforce it through appropriate administrative and judicial structures.

The European Commission first assessed progress made by the then candidate countries with respect to these criteria in the 1997 Opinions. Thereafter, the Commission, at the request of the Council, submitted annual 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.

The economic sub-criteria

Regarding the economic criteria, the Commission applies a set of sub-criteria to examine the progress achieved during each year. The compliance with the functioning market economy criterion is thus evaluated against the following five sub-criteria:

- high quality of economic governance
- achieved macroeconomic stability (including adequate price stability and sustainable public finances and external accounts);
- proper functioning of the goods and services market (including business environment, state influence, and privatisation and restructuring);
- proper functioning of the financial market (including financial stability, and access to finance);
- proper functioning of the labour market;

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

- a sufficient amount, at appropriate costs, of human capital, education, research, innovation, and future developments in this field;
- a sufficient amount and quality, at appropriate costs, of physical capital and infrastructure;
- changes in the sector and enterprise structure in the economy, including the role of the SMEs;
- the degree and the pace of the economic integration with the Union, and price competitiveness;

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

Progress towards meeting the economic
criteria for EU accession:
the EU Commission's 2016 assessments

1. ALBANIA

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

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. 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.

1.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Albania is moderately prepared in developing a functioning market economy. Some progress was made in improving the budget balance, fighting informality and reforming the electricity sector. The comprehensive judicial reform started and needs to be fully implemented to significantly improve the business environment. Economic growth gained momentum and unemployment decreased but is still high. Public debt also remained high and has yet to start falling. The underexecution of the investment budget continued. Non-performing loans in the banking sector still constrained credit growth. Business-relevant regulations remained cumbersome and shortcomings in the rule of law continued to hamper enterprises and deter investments.

In line with the ERP policy guidance and in order to support long term growth, in the coming years, Albania should pay particular attention to:

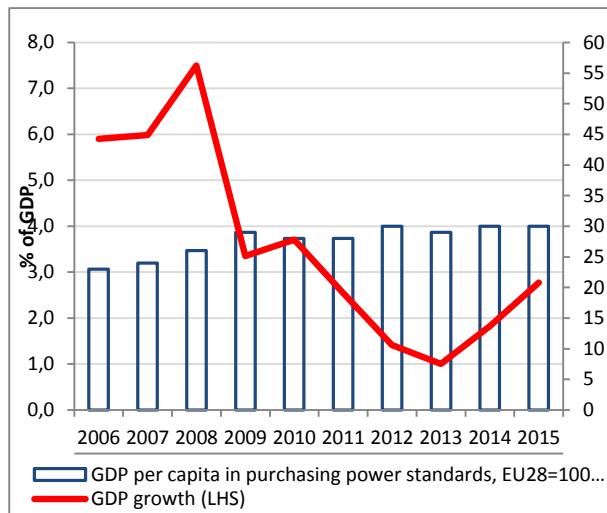
- pursuing efforts to improve tax revenue mobilisation to lower the public debt level whilst creating space for growth-enhancing spending;
- strengthening financial sector stability by implementing the non-performing loans action plan and developing a medium-term strategy to promote the use of the local currency;
- increasing the coverage of active labour market policies and improving the activation of unemployed and inactive persons, especially young people, women and the long-term unemployed.

Economic governance

Albania remained committed to strengthen macroeconomic stability and implement market-oriented reforms. Addressing the high level of public debt remained in the focus of macroeconomic policies. Reforms crucial to improving the business environment advanced but require further efforts to be completed. The ERP policy guidance from 12 May 2015 was only partially implemented but progress was made in most fields. Stability and growth are bolstered by the country's compliance with the conditions of the 3-year programme with the International Monetary Fund (IMF), agreed in February 2014.

Macroeconomic stability

Graph 1: Albania GDP growth



Albania's economic recovery gained strength on the back of rising investment. Economic growth bottomed out in 2013 but has been on an increasing trend since then, supported by government policies, increased consumer and business confidence and falling interest rates. Although external conditions were challenging, real GDP growth was 2.8 % in 2015 and accelerated further in the first quarter of 2016. It was driven by a strong revival in investment, which overturned a 3-year contraction, and a positive contribution from foreign trade. Despite strengthened economic activity, per capita GDP in purchasing power standards stood at only 30 % of the EU-28 average in 2015, practically unchanged since 2009.

The current account deficit remained high, but its financing has been healthy. Albania has historically run a substantial trade deficit caused by a narrow production and export base, and partly funded by remittances from Albanians living abroad. In 2015, the current account deficit narrowed to 11.3 % of GDP from 12.9 % recorded a year earlier. The trade balance improved thanks to the good performance of tourism, which offset decreasing earnings from goods exports, especially of oil. The value of imports also fell. At 5.8 % of GDP, remittances remained much below their level from before the global financial crisis. Foreign Direct Investment (FDI) inflows, which have been relatively high since 2007, amounted to 8.5 % of GDP in 2015 and continued to finance the bulk of the current account deficit. Foreign exchange reserves rose substantially in 2015, driven by FDI inflows and increased government borrowing on international markets. The reserves covered 6.6 months of imports at year-end, providing an adequate safeguard against adverse shocks.

Table 1.1:
Albania - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	2.5	1.4	1.0	1.8	2.8	3.1
Private consumption	Ann. % ch	1.8	0.1	1.8	3.0	-0.4	2.8
Gross fixed capital formation	Ann. % ch	5.9	-7.9	-2.0	-4.0	12.5	5.2
Unemployment rate	%	14.3	13.8	16.4	17.9	17.5	16.4
Employment	Ann. % ch	4.9	1.2	-4.4	0.9	5.2	5.8
Wages, public sector	Ann. % ch	7.0	7.3	4.1	1.7	1.8	1.0
Current account balance**	% of GDP	-13.2	-10.2	-10.9	-12.9	-10.7	-12.1
Direct investment (FDI, net)**	% of GDP	6.6	6.8	9.6	8.2	8.0	7.0
CPI, average	Ann. % ch	3.4	2.0	1.9	1.6	1.9	0.7
Exchange rate LEK/EUR	Value	140.33	139.04	140.26	140.14	139.74	138.28
General government balance	% of GDP	-3.5	-3.4	-5.0	-5.2	-4.0	1.1
General government debt	% of GDP	59.4	62.1	70.4	72.1	72.7	70.9

** refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat

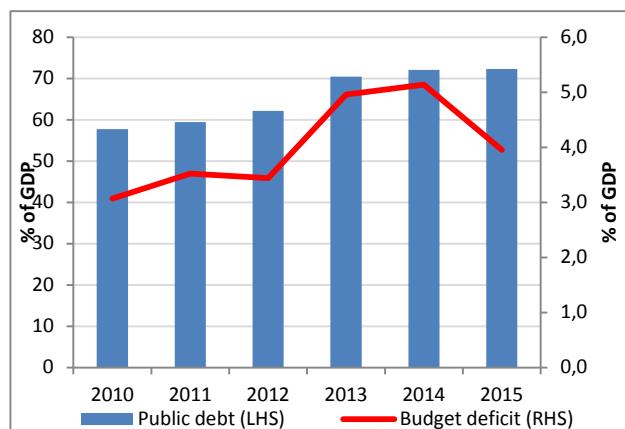
Inflation continued to be below the official target, prompting further monetary easing. Average annual inflation has remained below the central bank's 3 % target since 2012, reaching 1.9 % in 2015. It decelerated further in the first eight months of 2016 to just 1 %, reflecting low prices for imported products and weak domestic inflationary pressures due to still below-potential economic output. The central bank reacted by continuing to cut the key interest rate to a record low of 1.25 % in May 2016 and signalling its intention to keep the interest rate low for an extended period.

Loan interest rates also decreased, but bank lending was hampered by risk-averse banks reluctant to extend credit amid a still high level of non-performing loans (NPLs). The freely floating exchange rate of the lek has remained remarkably stable against the euro in the last 5 years.

High public debt poses macroeconomic risks and requires sustained fiscal consolidation to which the authorities remain committed. Public debt relative to GDP has been rising since 2011 and now exceeds 70 %, which is high compared with regional peers and Albania's capacity to generate revenue to pay off the debt. Most of the domestic debt is short-term and must be frequently refinanced. This refinancing relies mainly on a few domestic banks. In 2015, Albania successfully borrowed from international markets, enabling the government to pay off some domestic debt and extend the average maturity of the debt stock. However, as Albania borrowed in foreign currency, the country's exposure to exchange rate risk increased.

ERP policy guidance: 'Pursue fiscal adjustment by ensuring that revenue and expenditure targets and, by extension, the deficit target, are met. Evaluate and quantify fiscal risks stemming from all active public-private partnership and concession contracts and from local government arrears.'

Graph 2: Albania fiscal developments



Under its ongoing programme with the IMF, Albania undertook to strengthen debt sustainability and clear its substantial stock of arrears to businesses. Progress was made on both fronts. The identified stock of arrears was repaid ahead of schedule in 2014-2015. The budget deficit was lower than planned in 2014 and met the 4 % of GDP target in 2015.

Tax revenue in 2015 came in much lower than planned, reflecting overoptimistic assumptions and external shocks such as the oil price fall. Expenditure also underperformed, highlighting significant

and recurrent shortcomings in the management of public investments. In an effort to tackle this issue, the Ministry of Finance, which oversees overall budget execution, was assigned responsibility for this portfolio at the beginning of 2016. Economic growth and efforts to improve tax compliance led to a marked increase in tax receipts in the first seven months of 2016. Expenditure remained significantly below budget. Public debt relative to GDP is expected to start falling this year.

Several steps have been taken to improve fiscal governance and address fiscal risks. Ambitious public finance management reforms are under way with EU budget support, albeit with delays. A fiscal rule was adopted in June 2016. The rule mandates a long-term debt ceiling of 45 % of GDP and budget balances that ensure a falling debt ratio until the target is reached. However, there is neither a deadline for the target to be reached nor an independent body to monitor compliance. Fiscal reforms were adopted to address the persistent optimism bias in economic forecasts; make medium-term budget plans more binding; and increase transparency over public-private partnerships. Albania amended the terms under which it compensates former property owners expropriated under Communism to make the scheme

ERP policy guidance: 'Underpin fiscal consolidation by improving the fiscal framework; in particular, (i) strengthen medium-term budget plans by empowering the parliament to approve binding three-year ceilings at programme level and by clearly showing in the Medium Term Budget Programme which funds are effectively committed and which are new expenditure under the ceiling; (ii) move decisively towards adopting a fiscal rule which ensures debt sustainability, counter-cyclicity and transparency.'

more sustainable financially. However, the constitutionality of the new arrangement has been challenged.

The macroeconomic policy mix has been appropriate. Reducing the budget deficit is necessary to strengthen the sustainability of public debt. Keeping the key interest rate low is appropriate as it helps to raise weak inflation and economic activity. Lower domestic borrowing by the government also allows the private sector to borrow more to finance investments and consumption.

The functioning of product markets

Business environment

Procedures for market entry were further streamlined and business registrations soared, but the new bankruptcy law has yet to be adopted. A single service window for business registration and licensing became operational in April 2016, also offering online services. The number of newly registered businesses more than doubled in 2015, reflecting multi-pronged government action against widespread informality. The upward trend continued during the first quarter of 2016. However, firms' access to formal finance, especially in the start-up phase, remained a challenge. A new bankruptcy law to streamline burdensome market exit procedures, avoid abuse and facilitate collateral recovery has been in the pipeline for several years but has not yet been approved.

Businesses continued to face a cumbersome regulatory environment. Efforts were made to facilitate doing business and improve government communication with enterprises, but they have yet to produce tangible results on the ground. A draft law to streamline complex and inconsistent tax procedures has been prepared but has not yet been adopted. The partial moratorium on building permits, imposed in the wake of the local administration reform, was lifted, and construction activity returned to growth.

Deficiencies in the rule of law continued to hamper the business environment, but the justice reform advanced. The informal economy is estimated to account for more than a third of GDP, leading to tax revenue losses, a lack of labour protection and unfair competition among firms. Inefficient contract enforcement, uncertain property rights and the prevalence of corruption are major concerns repeatedly expressed by businesses. The wide-ranging judicial reform, which aims to tackle these interlinked problems, made significant progress with the unanimous parliamentary approval of constitutional amendments in July. Its successful implementation requires further legislative action and institution-building. Better governance, a more predictable and consistent enforcement of rules and a more efficient delivery of public services would substantially enhance the business environment.

ERP policy guidance: ‘Strengthen administrative capacities to ensure smooth legal land registration, the full functioning of the cadastre in general and especially the e-cadastre until 2019. Implement the e-procedure for building permits in order to cut red tape and encourage investments.’

State influence on product markets

State presence in the economy remained limited and the electricity sector is to be weaned off public support. The share of public revenue and spending in GDP remained relatively low. Total reported State aid stood at 0.4 % of GDP in 2015 but enforcement of State aid rules remained underdeveloped. The electricity sector reform led to a substantial decrease in distribution losses and some improvement in bill collection rates, strengthening the financial situation of state-owned enterprises in the sector. Albania expressed its intention to eliminate by 2020 all power sector subsidies, including public guarantees and policy net lending.

Privatisation and restructuring

Albania is advanced in market liberalisation and privatisation. The private sector remained dominant in the economy, providing more than 80 % of jobs. The State's involvement in the economy remained limited and was concentrated in a few sectors such as energy. The 2015 power sector law provides for a specific timeframe for further market liberalisation, starting from June. Albania renegotiated the terms of the concessionary agreement for the management of Tirana airport, removing its monopoly on international flights. In April, Albania privatised the fully state-owned insurance company INSIG. Privatisation plans for the oil company Albpetrol were put on hold as falling oil prices have reduced investor interest.

The functioning of the financial market

Financial stability

The banking system continues to be stable but is exposed to risks. Banks overall maintained adequate buffers to absorb shocks as capital adequacy and liquidity ratios largely exceeded regulatory requirements. Banking sector profitability improved in 2015 but fell in the first half of 2016. Banks are not reliant on foreign-based parent banks for funding because the ratio of loans to domestic deposits is only 53 %. Loan euroisation remained high: foreign currency loans to unhedged borrowers still make up around a third of the total loan stock, making their repayment vulnerable to a sharp depreciation of the lek. Government securities represent almost a quarter of bank assets, exposing banks to sovereign risk as well.

Access to finance

There is scope for banks to expand lending and better support the economic recovery. The banking sector, dominated by foreign banks, holds over 90 % of all financial system assets. With loans to businesses and households amounting to 35 % of GDP, there is much scope for increased bank lending. However, credit growth has been sluggish in recent years despite the gradual fall in interest rates as a result of both a low demand for and a tighter supply of bank loans. Banks' willingness to lend was affected by the high proportion of NPLs, which was still 21.2 % in July. The government and the central bank agreed on a comprehensive NPL action plan in September 2015 that involves legislative and regulatory measures and is expected to speed up NPL resolution and credit recovery.

ERP policy guidance: 'Continue to address risks to financial stability and the real economy by following-up on the NPL action plan which has been adopted and developing a medium-term strategy to promote the use of the local currency in the financial system, including all relevant stakeholders. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as the path of fiscal consolidation remains favourable, but risks related to further policy easing should be carefully assessed.'

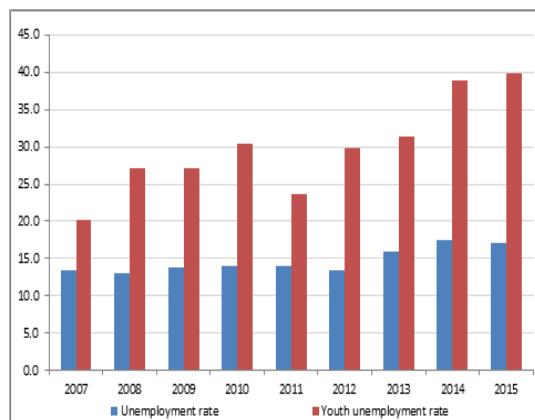
The size of the non-banking financial sector increased but remained small. It comprises the insurance and private pension businesses plus investment funds; total assets represent 6.6 % of GDP. The capital market is rudimentary and the stock exchange remained closed. There is great scope for expanding equity finance.

The functioning of the labour market

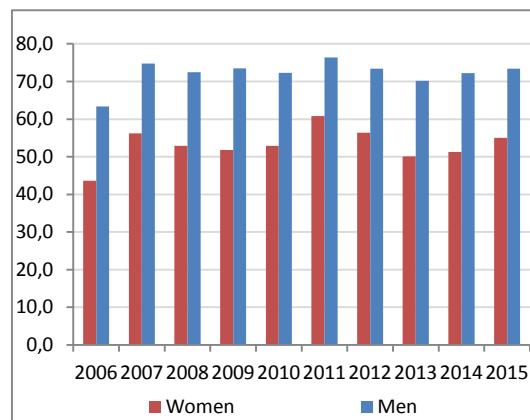
Strengthening economic activity improved labour market conditions but unemployment, especially of young people, remained high. The economic recovery created jobs and the employment rate rose to 52.9 % in 2015 from a low of 49.9 % in 2013 (15-64 years). Over 40 % of the workforce is employed in agriculture, mostly in low-skilled jobs, and informal employment

remains widespread. Labour force participation also increased, to 64.2 %, possibly reflecting improved employment prospects and a decreasing trend in remittances. Active labour market policies expanded from a low base but they still covered only around 4 % of the unemployed.

Graph 3: Unemployment in Albania
(% of Active population)



Graph 4: Participation rates in Albania
(% of Labour Force)



There is a large and persistent difference in the labour force participation of women and men with the rate for women around 18 percentage points lower than for men, highlighting large structural problems in the labour market. The unemployment rate (15-64 years) fell from 17.9 % in 2014 to 15.9 % in mid-2016. The unemployment rate for young people (15-29 years) also declined but remained very high at 29.9 %, highlighting substantial skill mismatches. A relatively high minimum wage might also act as a disincentive for hiring low-skilled and young people.

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

Albania has **some level of preparation** in terms of capacity to cope with competitive pressure and market forces within the Union. **Some progress** was made particularly as regards improving higher and vocational education as well as prioritising infrastructure investments. However, the quality of education needs to be raised at all levels to better equip people with skills in line with labour market needs. Gaps in transport, energy and digital infrastructure still hinder Albania's competitiveness and constrain trade, which remains below potential and sectorally concentrated. Albania's capacity for research, development and innovation remains low.

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

- improving the quality of the education system;
- further liberalising the energy market in accordance with the Energy Community Treaty, in particular by unbundling transmission and distribution activities in order to improve energy security and allow the market entry of independent operators;
- facilitating trade through simplifying procedures and removing non-tariff barriers.

Education and innovation

Albania still has considerable gaps to close between education outcomes and labour market needs. Public spending on education remained low at less than 3 % of GDP. The quality of basic

education is low as illustrated in the low ranking of Albanian students in the OECD's PISA¹ tests. Pre-primary (3-6 years) enrolment rates are very low at 33 %, undermining efforts to create a level playing field for the beginning of primary school.

High youth unemployment and high unemployment even among well-educated people are signs of the need for improved quality and relevance of the education received. A large share of enterprises reported lack of appropriately skilled workers.

The new law on higher education was adopted and preparations for accrediting higher education institutions started as well as the implementation of the new decentralised selection procedure for university admission. Gradual progress was made in establishing VET multifunctional centres and work continued on the national qualification framework.

Albania's capacity for technological absorption and research, development and innovation (RDI) is low. Key obstacles include low expenditure on research and development (about 0.4 % of GDP); weak links between the scientific and private sectors; as well as fragmentation of the national research and innovation system. As a result of this weak innovation policy infrastructure, almost all sectors of the economy mainly provide low-technology, labour-intensive and low-cost products and services. Increased funding and a more focused RDI strategy in a number of specific sectors, particularly in energy, agro-food and sustainable tourism, would support the country's capacity to attract investment in RDI.

Physical capital and quality of infrastructure

The decline in investment was reversed in 2015 but further measures are needed to sustain capital expenditure.

Investment as a share of GDP decreased from 33.9 % in 2008 to 24.6 % in 2014 and fell also in nominal terms in 2012-2014. However, in 2015 rising energy-sector FDI inflows led to double-digit real growth in investment. Domestic saving is too low to match the substantial investment needs of the Albanian economy, which remains reliant on FDI inflows to enhance competitiveness and productive capacities. The lack of a functioning cadastre and clarity of land ownership is a significant impediment to investment. Some progress was made on strengthening the investment policy framework, notably by adopting implementing regulations of the law on strategic investments and by reorganising the investment promotion agency. Public investment made up more than 5 % of GDP in past years, but was often affected by ad hoc spending cuts.

ERP policy guidance: 'Fully implement the obligations under the Energy Community Treaty including, in particular, the full unbundling of transmission and distribution activities in the electricity and gas sectors in order to improve energy security and allow market entry of independent operators.'

Albania's transport and energy infrastructure is still not sufficiently developed. Better connections to neighbouring countries and the EU transport network would reduce transportation costs and facilitate trade. Investment in the core transport network has been prioritised by the creation of a single sector project pipeline which includes national priority projects. However, Albania has not yet implemented the connectivity reform measures agreed under the Berlin process.

Inadequate electricity supply remained a key structural challenge increasing costs to businesses. Progress was made on electricity sector reform: the financial viability of state-owned utility companies was strengthened and infrastructure improved, particularly with the completion of the transmission interconnection between Albania and Kosovo. The construction of the TAP major gas

¹ OECD's Programme for International Student Assessment

pipeline started. There are plans to use public-private partnerships to improve infrastructure, but such projects will need to be transparent and fiscally sound.

The digitalisation of the economy is low but advancing. Penetration of fixed broadband internet is only 9 %, while mobile broadband reached 46 % of the population by end-2015. E-government is more advanced with a portal (e-Albania) offering the possibility for online applications for initial business registration, submission of annual financial statements, consulting of business records, etc. Online banking and e-commerce are rising and have a large potential for further expansion.

Sectoral and enterprise structure

The Albanian economy is dominated by services, but agriculture still retains an important role. In 2015, services accounted for slightly over half of gross value added, followed by agriculture with a share of 22.1 %. Industry's share has gradually increased since 2007, to 14.6 % of the economy, mainly as a result of rising crude oil production. The manufacturing sector is relatively small (6.3 % of gross value added) and mainly produces low value added and labour-intensive products such as textiles and footwear. Construction's share of the economy greatly diminished over recent years as private credit and investment weakened but in 2015 it registered a first slight increase since 2007, rising to 10.8 %.

The sectoral concentration of goods exports remained high in 2015, with 78 % of the total accounted for by a limited number of products: textiles and footwear (37 %); minerals, fuel and electricity (26.5 %); and construction materials and metals (14.5 %). This lack of diversification contributes to the large external deficit and exposes the economy to industry-specific shocks, as highlighted by the oil price fall's impact on Albania's exports.

SMEs play a significant role in the economy. They provide 80 % of employment and two-thirds of value added in the non-agricultural private sector. Micro-businesses in particular make up a high proportion of the number of companies and account for 43 % of jobs. Various state- and donor-funded schemes support SMEs' competitiveness but further steps need to be taken to strengthen their innovation capacity and improve their access to finance, such as developing the venture capital market.

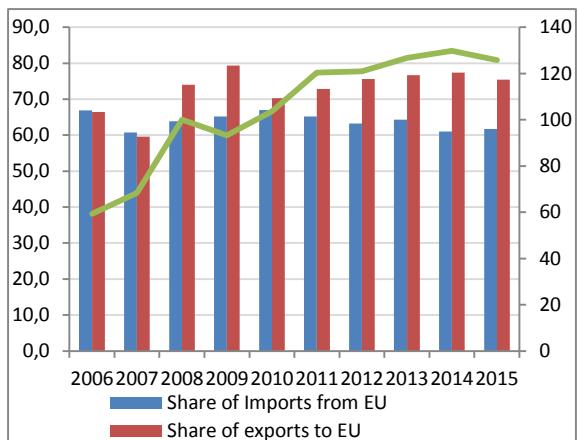
Economic integration with the EU and price competitiveness

The EU is Albania's dominant trading partner, but overall trade remains below potential. With total imports and exports amounting to only 71.7 % of GDP, Albania has considerable scope for increasing trade. A better integration into global supply chains would help boost productivity and create more and better jobs.

The EU accounted for 75 % of Albania's goods exports and 61.3 % of its goods imports in 2015. Italy is the main destination for Albanian exports, absorbing around half of Albanian goods sold abroad and providing 30 % of its goods imports.

Trade links with Central European Free Trade Agreement (CEFTA) countries are also relatively significant, mainly on account of exchanges with Kosovo. Taken together, Albania's six CEFTA partners accounted for some 14 % of Albanian goods exports and 8 % of its goods imports in 2015. These shares are largely unchanged since 2008, pointing to a large untapped potential for future growth if intra-regional connectivity improves. The existence of certain technical barriers to trade still inhibits further trade growth.

Graph 5: Albania trade integration with the EU



The EU remains the main source of FDI into Albania with a share of around 65 % of the total FDI stock.

In terms of price and cost competitiveness, the real effective exchange rate appreciated by 3.7 % in the 12 months preceding June, while unit labour costs remained lower than in most regional peers.

1.3. CONCLUSIONS

As regards the **economic criteria**, Albania is moderately prepared in developing a functioning market economy. Some progress was made in improving the budget balance, fighting informality and reforming the electricity sector. Economic growth accelerated and the labour market situation improved, but unemployment is still high. Public debt is high and has not yet started decreasing, while the recurrent underexecution of government spending on investments persists. The financial sector is stable. However, the banking sector is still burdened with non-performing loans and credit is growing slowly. Business-relevant regulations are cumbersome and shortcomings in the rule of law continue to deter investments. The ongoing justice reform is expected to have a material impact on the business environment.

Albania has some level of preparation concerning its capacity to cope with competitive pressure and market forces within the Union. Some progress was made particularly as regards improving higher and vocational education. However, the quality of education needs to be raised at all levels to better equip people with skills and knowledge in line with labour market needs. Efforts have started for prioritising infrastructure investments, but gaps in transport, energy and digital infrastructure still hinder competitiveness and constrain trade. International trade is below potential and it is sectorally concentrated making the economy more vulnerable. Capacity for research, development and innovation remains low.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

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

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. 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

The former Yugoslav Republic of Macedonia has a **good level of preparation** in developing a functioning market economy. However, **no progress** was made during the reporting period. Macroeconomic stability was preserved and the macroeconomic environment strengthened further in 2015, supported by major public infrastructure spending and foreign direct investment, although with signs of weaknesses in the first quarter of 2016. Unemployment is decreasing, but remains high, particularly for youth. Certain vulnerabilities remain, such as the low competitiveness of the domestic private sector which is hampered by weak contract enforcement, the large informal economy, and difficult access to finance. The management of public finances did not improve. In addition to the sustained large fiscal deficits over the past years, the rising financing needs of state-owned enterprises managing the government's investment agenda are driving up public debt levels.

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

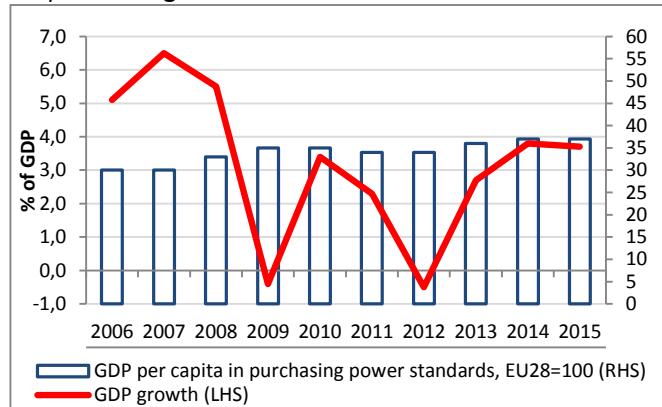
- underpinning fiscal consolidation by identifying concrete revenue and expenditure measures;
- moving towards a better targeting of transfer spending and improving the growth-friendliness of public finance;
- improving fiscal transparency and budget planning capacity.

Economic governance

The government remains committed to promoting growth and employment by market-based economic policies. Support to private sector competitiveness, public infrastructure developments, and export promotion remained the pillars of the government's economic policy. However, employment is boosted by large-scale government programmes as well as active labour market measures, rather than by job creation in private local enterprises. Commitment to fiscal consolidation is lacking, as the government failed to point out concrete measures, while repeatedly revising annual deficit targets upwards in mid-year. The ERP policy guidance from 12 May 2015 regarding macro-fiscal issues has not been addressed, while the guidance on labour market policies and on structural reform has been only partially addressed.

Macroeconomic stability

Graph 6: GDP growth



Economic expansion accelerated in 2015, but has slowed down in 2016 in the context of a political crisis.

After a real output decline in 2012, the economy posted stable growth rates averaging 3.4 % between 2013 and 2015. Since 2012, household consumption has become an increasingly important contributor to growth, while investment and the foreign balance proved volatile. The construction sector was the fastest growing industry in this period. In 2015, real GDP increased by 3.7 %, driven by domestic consumption and net exports. Overall investment remained flat, in spite of strong public infrastructure spending. Growth lost momentum in the first half of 2016, averaging 2.1 % year-on-year. The average per-capita income (purchasing power standards) amounted to 37 % of the EU-28 average in 2015, an increase of 3 percentage points (pp) since 2012.

Short-term external vulnerabilities remained contained. The current account deficit has remained moderate in recent years. In the four quarters to June 2016, it stood at 2.5 % of GDP, albeit higher than its average of 1.5 % of GDP over the past five years. The rise in 2016 came largely on account of a widening merchandise trade deficit, which remains large, at 19.9 % of GDP, yet lower than on average between 2011 and 2015 (23.2 %). The trade deficit has been covered historically by robust private transfer inflows, significantly alleviating external imbalances. While still more than compensating for the current account deficit, foreign direct investment inflows dropped to 1.9 % of GDP in 2015, compared to an average of 2.7 % in the preceding five years, as companies adjusted to new tax legislation, and the political crisis lingered on. The composition of new FDI, shifting from equity to debt financing, has become more volatile and less conducive to structural change in the economy in recent years.

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

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	3.0	-0.5	2.7	3.5	3.7	2.1
Private consumption	Ann. % ch	7.4	1.2	2.1	2.4	3.1	2.9
Gross fixed capital formation	Ann. % ch	15.7	21.2	-16.8	15.2	0.1	0.1
Unemployment rate	%	31.4	31.0	29.0	28.0	26.1	24.3
Employment	Ann. % ch	1.1	0.8	4.3	1.7	2.3	2.8
Wages	Ann. % ch	1.3	0.2	1.2	1.0	2.7	2.1
Current account balance**	% of GDP	-2.9	-3.2	-1.6	-0.5	-2.1	-2.1
Direct investment (FDI, net)**	% of GDP	4.6	1.7	3.3	2.3	2.2	2.3
CPI, average	Ann. % ch	3.9	3.3	2.8	-0.3	-0.3	-0.4
Exchange rate MKD/EUR	Value	61.53	61.53	61.58	61.62	61.61	61.69
General government balance	% of GDP	-2.5	-3.8	-3.8	-4.2	-3.5	-2.5
General government debt	% of GDP	27.7	33.7	34.0	38.1	38.1	37.0

** refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat

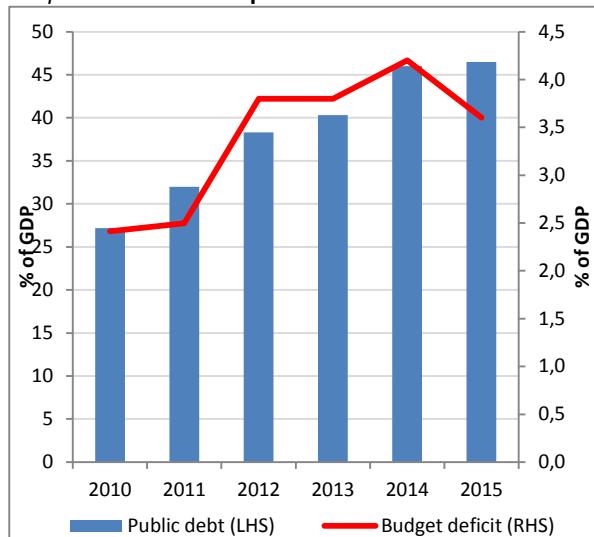
Public sector borrowing abroad impacts on external debt. The external debt of the country has been rising rapidly since 2009 (+14pp), as the public sector increasingly resorted to foreign financing. Private sector indebtedness abroad increased, too. At the end of 2015, external debt amounted to 70 % of GDP. Foreign exchange reserves declined in 2015, even though the government issued a Eurobond in November 2015 (EUR 270 million). Some of the loss was made up in the first quarter of 2016, and

reserves were further boosted by a EUR 450 million Eurobond issued in July 2016. Reserves coverage remains satisfactory at about 4 months of prospective imports.

ERP policy guidance: "Underpin fiscal consolidation by identifying concrete revenue and expenditure measures; move towards a better targeting of transfer spending and improve the growth-friendliness of public finance, in particular by fully executing planned priority public investment spending. Protect against fiscal risks by using any excess revenue to create fiscal buffers."

The central bank successfully defended price stability and the currency peg. After several years of easing, monetary policy has become more restrictive since mid-2015, motivated by broader-based economic growth, ample liquidity in the financial sector, and strong household credit growth. In May 2016, the central bank raised the key interest rate from 3.25 % to 4 %, in response to speculation-driven pressure on banks' deposits, and amid continuing subdued price pressures. In 2015, consumer prices dropped by 0.3 %, as in 2014, driven by declining fuel and transport prices, supported by lower food prices. Annual average inflation has been decreasing since 2011, when it stood at 3.9 %. The bank also effectively stimulated the "denarisation" of loans and deposits, reducing foreign exchange risks. The country's exchange rate is anchored through a de facto peg to the euro.

Graph 7: Fiscal developments



rather than specific savings. Yet, further ad-hoc increases in pensions, social transfers, and public wages are likely this year, as in previous years, while the pace of GDP growth is slowing down.

Revenue shortfalls due to over-optimistic growth assumptions and underperforming collection, as well as spending pressures, have repeatedly required the adoption of a supplementary budget and a higher deficit target in recent years.

ERP policy guidance: "Improve fiscal transparency and budget planning capacity by the swift introduction of a medium-term expenditure framework; by providing multi-annual projections of detailed revenue and expenditure components in the medium-term strategy as well as by comprehensive reporting of extra-budgetary expenditure in the consolidated fiscal reports. Inform systematically about payments arrears."

Revenues have been overestimated by an average of 6 % in the last five years. In June 2016, the government resorted again to a supplementary budget, with a further revision in August. On average between 2009 and 2015, 62 % of total expenditure was devoted to transfers, especially pensions. In the same period, only about 84 % of budgeted capital expenditure was implemented.

Public debt levels have been rising fast. An increasing amount of public capital expenditure has been shifted off-budget in recent years to state-owned enterprises (SOE), financed almost entirely by government-guaranteed credit. This, in addition to the rising primary fiscal deficits, has led to

accelerating increases in public debt, by 23.5pp, to 46.5 % of GDP between 2008 and 2015. There is little transparency about the fiscal risks linked to the execution of sizeable public infrastructure works through state enterprises. Meanwhile, the government has successfully lengthened its debt maturities, and only a small share remains (domestic) short-term debt.

The policy mix does not fully address the economic challenges. To promote sustainable growth and employment and contain risks to external balances, economic policy needs to focus on supporting the domestic private sector; targeting labour market weaknesses, and, diversifying the economy's structure. This would be aided by better targeted public expenditure and strengthened efforts at fiscal consolidation and debt stabilisation. The external borrowing of public sector bodies needs close monitoring so as to avoid challenges to monetary policy through its impact on domestic liquidity.

Functioning of product markets

Business environment

Business development suffers from weak and uneven law enforcement. Low corporate taxation and simplification of regulatory requirements are cornerstones of the government's policies to facilitate business operations. Yet, obtaining licences and permits for operation is perceived to be easier for foreign investors than domestic companies, which is one of the key issues for domestic businesses. Moreover, opaque interpretation of business regulations, notably by local administrations, uneven enforcement of rules and contracts, as well as corruption and the large informal economy hamper private sector development. In 2015, the number of new businesses, as well as the amount of registered founding capital, declined, compared to the preceding year and to the five-year average, possibly reflecting in part the lingering political uncertainty.

ERP policy guidance: "Ensure a reliable and predictable regulatory environment for businesses by reducing the use of the urgency procedure for legislation, ensuring proper consultation of the stakeholders and reinforcing the independence of commercial courts."

Institutional capacities to enforce the law are weak. Resolving a commercial dispute through a court remains time-consuming and costly. Moreover, the efficiency of the judiciary system appears to be increasingly impacted by political interests. There were no new measures adopted on facilitating business exit, which remains challenging. Liquidation procedures after bankruptcy have been shortened in recent years, but still take about 1.8 years on average.

The sizeable shadow economy is an important obstacle to business. The informal share of the economy is large, impacting on the competitiveness of the formal private sector. Estimates range from some 20 % of total output (State Statistical Office) to about 40 %, depending on the method applied. This creates problems of competition for registered companies and obstacles to investment. Policy measures in recent years were aimed at reinforcing the capacities of public bodies, involved in tackling the informal economy, as well as changes to tax and labour legislation intended to reduce labour cost and enhance the incentives for formal employment.

State influence on the product market

The public sector's share of the economy remains contained, yet discretionary policy enforcement by the government creates concerns. The value of state assets in GDP amounted to 13 % of GDP in 2015, having declined marginally, but steadily over the past five years. Yet, while the state's stake in the economy remains moderate, the involvement of the government in the private sector is growing in other ways, such as through uneven application of rules and regulations, inspections, and public procurement procedures. There is limited information on amounts and beneficiaries of state aid. The large share of state-owned land remains an obstacle to the development

of the agricultural sector and prevents this land from being used as collateral by private owners seeking a bank loan.

Energy prices are still largely set by the Energy Regulatory Commission (ERC). After the government postponed the liberalisation of the electricity market in 2014 by 5 years, contrary to the agreement of the EU Energy Community, electricity prices for households and small companies remain regulated by the ERC, with a schedule to allow gradual adjustment between 2016 and 2020. Prices paid by households do not cover cost and are cross-subsidised by prices charged to small companies. Natural gas prices, too, remain in the ERC's remit, even though legislation was adopted in 2015 to open the market. Oil and oil derivatives prices are also regulated, but follow global market prices. Administered and regulated prices accounted for 15 % of the CPI basket in 2015, largely unchanged from previous years.

Privatisation and Restructuring

The privatisation process is at an advanced stage. In 2015, there were no further privatisations, and the number of enterprises in full or partial state ownership remained unchanged from a year earlier. The value of state assets in GDP amounted to 13 % of GDP in 2015, having declined marginally, but steadily over the past five years. The implementation of a joint-venture between a state-owned company and a multinational tobacco enterprise is ongoing.

Functioning of the financial market

Financial stability

The banking sector shows resilience in the face of lingering credit risk. The financial sector remains dominated by banks which account for about 90 % of the system's assets. Concentration remains high and unchanged compared to previous years, with about 60 % of assets held by the three biggest banks, out of a total of 15 banks operating in the country. The solvency ratio amounted to about double of the domestic supervisor's required minimum level of 8 %. Banks' profitability rose markedly in 2015. The quality of banks' assets, however, did not improve. The ratio of NPL to total loans to the private sector amounted to 11.4 % on average in 2015, only slightly below the average in 2014, and has declined only marginally

since then. There was some progress in reducing the amount of non-performing loans as the central bank imposed an obligation on banks to write-off fully-provisioned loans that have been on their books for more than 2 years, with effect in June 2016.

ERP policy guidance: "Develop comprehensive strategies involving all relevant stakeholders in order to both further foster the resolution of non-performing loans by banks and further promote the use of the local currency with a view to reducing risks to financial stability and the real economy. There would be a case for a gradual removal of the central bank's accommodative monetary policy stance to the extent that authorities' sanguine macroeconomic scenario is realised (including through its impact on inflation expectations and on the output gap)."

Access to finance

Credit growth to companies slows amidst political uncertainty. Access to finance still remains difficult for SMEs, given impediments to both credit supply and demand, despite abundant liquidity of banks. Financial intermediation strengthened in 2015 compared to the preceding two years, with assets, credit and deposits rising as a share of GDP. Commercial bank loans remain by far the dominant source of financing, as SMEs are reluctant to tap equity and bond markets, and venture capital markets remain in their early stage of development. Loan growth to private households (12.4

% yoy on average in 2015) was almost double the growth rate of credit to non-financial companies, which has slowed down markedly since summer 2015. In order to curb the growth of long-term consumer loans, the central bank increased capital requirements on these assets in December 2015. Given the uncertain political situation, credit demand from SMEs and corporates has been subdued since mid-2015. To facilitate credit extension to SMEs, the government, in 2015, withdrew the last tranche of a credit line for SME development extended by the European Investment Bank. However, no other significant policy measures were adopted in 2015 to facilitate access to finance for SMEs.

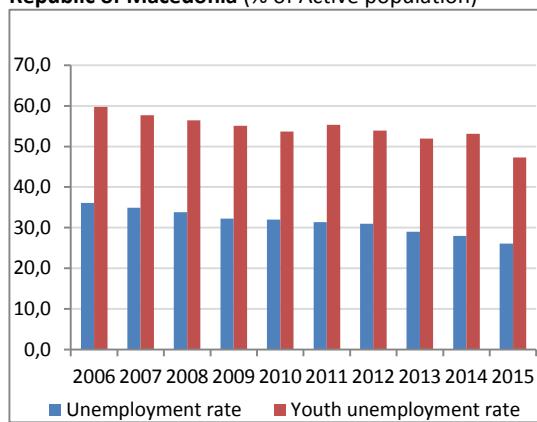
Functioning of the labour market

Structural weaknesses hinder the functioning of the labour market. The country's overall unemployment rate remains persistently high, in particular for long-term unemployed and young workers, albeit declining steadily in recent years. In the second quarter of 2016, it dropped to 24 %, down by 2.8pp on the year. Between 2011 and 2015, the economy has created a large number of jobs. Annual employment growth amounted to 2.5 % on average, carried by job creation in the public sector, in construction and manufacturing, and through active labour market measures. Yet, the employment build-up was not in line with output growth, as significant structural weaknesses of the economy impede the functioning of the labour market.

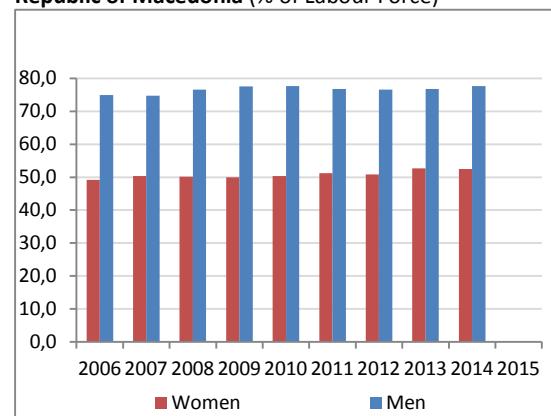
ERP policy guidance: "Strengthen the provision of activation measures especially for vulnerable youth, women and long-term unemployed and further improve the capacity of the Employment Service Agency for profiling and personalised counselling of job seekers."

Labour force participation remained modest. The activity rate has been stagnant over recent years, at about 70 % of the working age population (20-64 years). The employment rate has increased only marginally – only 52 % of the working age population held a job in 2015. Given low female participation rates, the gender gap remains important, with women less likely to be in employment (42 %) than men (62 %).

Graph 8: Unemployment in the former Yugoslav Republic of Macedonia (% of Active population)



Graph 9: Participation rates in the former Yugoslav Republic of Macedonia (% of Labour Force)



The informal economy accounts for a large, but shrinking share of employment. About 20 % of employment took place in the informal economy in 2015, down from 28.6 % in 2008. Informal work concerns especially young workers and long-term unemployed. To tackle the problem, the government introduced a programme waiving or reducing social contributions for newly hired registered unemployed workers for a period of up to five years. The programme has been extended for another year.

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

The economy has a **moderate level of preparation** to cope with competitive pressures and market forces within the Union. **Some progress** was made to foster innovation and foreign investments and digitalisation is progressing fast. There was a limited shift towards higher value added in manufacturing, but the structural transformation towards a more diversified economy is progressing slowly. The economy continued to suffer from weaknesses in education curricula, low innovation rates and significant investment needs including in public infrastructure.

In order to support long-term growth, in the coming year the former Yugoslav Republic of Macedonia should pay particular attention to:

- upgrade higher education and vocational curricula, so as to better align skills with labour market needs;
- improve the innovation infrastructure in order to promote the competitiveness of the domestic private sector.

Education and innovation

Higher education needs reforms to address the skills gap. The country has suffered from a marked drain of skilled workers since the 1990s, the rebuilding of which proves difficult given low enrolment rates and deficiencies in the education system. Shortcomings in tertiary and vocational education often impede applicants from gaining skills required to work in technology-intensive sectors. This restrains output potential and impedes the reallocation of resources towards sectors with higher productivity and the spread of imported technology to the domestic economy. Public expenditure on education, at 4 % of GDP, is only slightly lower than the EU average, yet enrolment rates (18 % for pre-school, 91 % for primary school and 73 % for secondary school education) and attainments have improved only marginally over the past five years, pointing to certain weaknesses in the education and training programmes. The employment rate of higher education graduates is above the average of the economy, yet completion rates are low. The share of early school leavers remained constant at 12 % of total students. Modernisation of the VET programmes is currently underway, yet the implementation of the 2013-2020 Strategy is lagging. The country participated in the PISA¹ assessment for the first time in 2015, but results are not yet available.

Innovation rates for the private sector remain low. Public and private expenditure on research and innovation, as a share of GDP remained modest, compared to the EU average, at 0.52 % in 2014, and only slightly higher than in 2010. The government has tackled this problem mainly by the creation of the Innovation Fund which started disbursements in 2015 to stimulate R&D in SMEs. However, the absorption capacities of SMEs for the Fund's instruments are limited, calling for measures to strengthen their skills and technologies.

¹ OECD's Programme for International Student Assessment

Physical capital and quality of infrastructure

The economy's capital stock is in need of modernisation. The country's capital base is in need of renewal, even though modern production plants by foreign investors and public infrastructure investments have led to some upgrading in recent years. The investment ratio has remained constant, at 23-24 % of GDP, between 2011 and 2014.

Some 70 % of investment was carried out by private enterprises (domestic and foreign), while the remainder is public investment financed through the government budget, international financial institutions, and public enterprises. The National Investment Committee, charged with the preparation and implementation of infrastructure investments, was created in June 2015, but there are concerns as to its efficiency.

ERP policy guidance: "Adopt a credible public finance management reform programme. Prioritise public investments against clear policy objectives and identify the needs to which they respond. Increase the transparency on the selection criteria for the investments and on their impact on economic growth and on the fiscal path."

Regional connectivity in transport and energy is limited. Transport infrastructure linkages to regional neighbours and connection to the Trans-European Transport Networks remain a challenge. The country made, some progress, although limited, in implementing the connectivity reform measures agreed in the context of the Western Balkans Investment Framework. The focus should be on the establishment of functioning maintenance system along with the improvement of the capacities of the public enterprise in charge. The strategically important Corridor X motorway part is expected by the government to be completed by May 2017, turning the focus on road maintenance and the weak capacities of the public enterprise in charge. While the electricity transmission connection with Serbia has been completed, interconnection with Albania, which would link the country to the wider Corridor VIII network, is still in the planning phase.

The digitalisation of the economy is advanced. Both fixed and mobile broadband use has expanded in recent years, covering some 94 % of companies in 2015, compared to 87 % five years earlier. During this period, the share of households with internet access at home increased by 14pp to 69 %. The number of mobile phone subscriptions relative to population size stands at 100 %.

Sectoral and enterprise structures

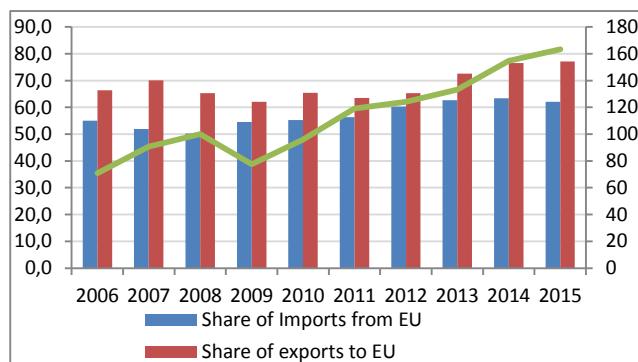
The structural transformation of the economy is progressing slowly. The sectoral structure of the economy has remained largely stagnant in the past five years. At over half of gross value added, services account for the largest share, with agriculture providing 10 %, and industry and construction another 22 % (of which manufacturing around 12-13 %). Yet, the structure of the manufacturing sector shifted somewhat from basic manufactured goods towards products of higher value (chemicals, machinery) in this period. Half of the economy's jobs are in services, followed by industry and construction (27 %) and agriculture (24 %), again without significant changes since 2011. The structure of the corporate sector and its contribution to output has also remained stable, with SME accounting for over 99 % of all companies, and providing over 76 % of value added in the economy.

Economic integration with the EU and price competitiveness

The EU is an increasingly important export market and the major investment partner for the country. Trade openness of the economy is high. The country's total value of exports and imports of goods and services amounted to 108 % of GDP in 2015, about the same as five years earlier. Merchandise trade with the EU has increased steadily in the past 10 years and amounted to 68 % of the country's total trade in 2015. Exports rose particularly towards Germany and Belgium, on account of the operations of foreign direct investors, at the expense of exports to CEFTA countries. Imports sourced in the EU increased by 3 % compared to the previous year. While the share of EU direct

investment inflows varies considerably (90 % of total in 2013; 7 % in 2014), the share of the stock of EU in total foreign investment has been high, but stagnant, at about 81 % over the past 5 years. Total Foreign Direct Investment (FDI) stock per capita and as percentage of GDP is, however, low.

Graph 10: Trade integration with the EU



rising since early 2014, yet by less than real net wages, which have been supported by subdued price pressures as well as by steady increases in nominal pay. Gross wages are broadly aligned with the average output per employed person. The real effective exchange rate (CPI-based) has remained largely stable in the past five years.

Improved external competitiveness hinges on further export diversification.

Change in the composition of exports remains slow, with limited progress towards higher value added products over the past five years. The shares of iron and steel products, as well as of clothing in total exports have fallen somewhat, while chemicals, and machinery and transport equipment became more important, mainly on account of foreign investment. After having declined for two years, labour productivity has been

2.3. CONCLUSIONS

As regards the **economic criteria**, the former Yugoslav Republic of Macedonia has a good level of preparation in developing a functioning market economy. Overall, no progress was made towards a functioning market economy during the reporting period. Macroeconomic stability was preserved and the macroeconomic environment strengthened further in 2015. This was supported by major public infrastructure spending and foreign direct investment, although signs of weaknesses were observed in the first quarter of 2016. Despite unemployment remaining high, particularly for youth, it has decreased during the reporting period. Certain vulnerabilities remain, however, such as the low competitiveness of the domestic private sector which is hampered by weak contract enforcement, the large informal economy, and difficult access to finance. The management of public finances did not improve and public debt increased further.

The economy has a moderate level of preparation to cope with competitive pressures and market forces within the Union. Some progress was made to foster innovation and foreign investments and digitalisation is progressing fast. The economy is poorly diversified, however, and manufacturing industry produces mainly low value-added products. The economy continued to suffer from weaknesses in education curricula, low innovation rates and significant investment needs, including in public infrastructure, that make it less competitive.

3. MONTENEGRO

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

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. 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.

3.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Montenegro is **moderately prepared** in developing a functioning market economy. **Some progress** was made to strengthen the functioning of the financial and labour markets, as well as on improving the business environment. Investments in infrastructure and tourism support economic activity. However, rapidly rising public debt and high fiscal deficits, together with high external imbalances and high unemployment are of concern. The combined effects of large-scale public infrastructure investments and several new expensive social expenditure programmes challenge fiscal sustainability. Immediate corrective measures are required, as called for by the ERP policy guidance. Other problems to be tackled include high external imbalances and low labour market participation and still low credit growth amid high impaired bank loans.

In line with the 2016 ERP policy guidance and in order to support long-term growth, Montenegro should pay particular attention to:

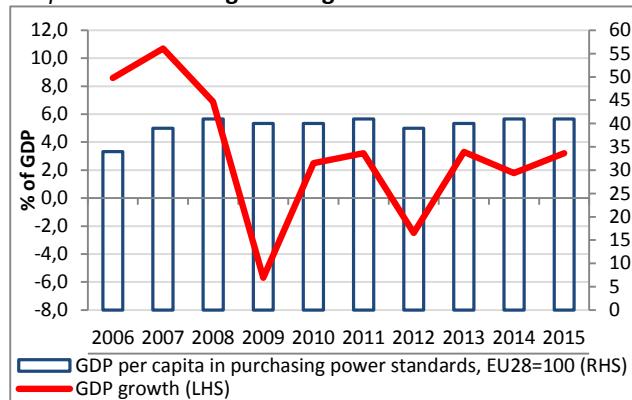
- stabilising and reducing public debt, including by adopting measures to restrain current spending and improve revenue collection;
- developing a comprehensive strategy to further foster the disposal of non-performing loans;
- prolonging working lives and reducing disincentives to work.

Economic governance

Prior to the October parliamentary elections, government and parliament lacked the commitment to adopt economic reforms. The measures presented in the 2016 ERP did not offer an appropriate policy response to cope with the economic challenges, and the ERP policy guidance agreed on 12 May 2015 has only been partially implemented. Meanwhile, important contingent reform measures and restructuring plans were postponed until a new government is formed following the parliamentary elections of October 2016. Overall, a strong political commitment to pursue a stable fiscal policy and structural reforms is needed to improve the economic situation of Montenegro.

Macroeconomic stability

Graph 11: Montenegro GDP growth



% y-o-y, down from 3.4 % a year before. GDP per capita (in purchasing power standards) was 41 % of the EU average in 2015.

The external deficit is very high. The current account deficit narrowed to 13.3 % of GDP in 2015, down from 17.6 % in 2011. However, this trend reversed in the first half of 2016 when the current account deficit rose to 18.0 % of GDP as the tourism-driven surplus in services did not suffice to offset the deterioration in the trade and primary income accounts. In 2015 the external deficit was financed by a sustained inflow of FDI from a diversity of countries. FDI inflows have remained close to or above 10 % of GDP since 2004. However, in the first half of 2016, there was a strong outflow of FDI as a result of recording transfers abroad of retained profits from one large company. In order to balance the financial account, a sizable inflow of transfers was recorded under net errors and omissions.

Table 3.1:
Montenegro - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	3.2	-2.7	3.5	1.8	3.4	1.9
Private consumption	Ann. % ch	0.5	-3.9	1.6	2.9	2.2	2.9
Gross fixed capital formation	Ann. % ch	-7.2	-2.4	10.7	-2.5	11.9	25.8
Unemployment rate	%	19.7	19.7	19.5	18.0	17.6	17.7
Employment	Ann. % ch	-6.1	2.2	1.1	7.1	2.5	1.3
Wages	Ann. % ch	1.0	0.8	-0.2	-0.3	0.3	2.6
Current account balance**	% of GDP	-17.6	-18.5	-14.5	-15.2	-13.3	-18.1
Direct investment (FDI, net)**	% of GDP	11.9	14.5	9.6	10.2	17.1	16.2
HICP, average	Ann. % ch	3.3	4.0	1.8	-0.5	1.4	-0.1
Exchange rate EUR/EUR	Value	1.0	1.0	1.0	1.0	1.0	1.0
General government balance	% of GDP	-5.4	-7.2	-5.2	-3.1	-7.3	-2.9
Central government debt	% of GDP	45.6	53.4	57.6	54.8	61.2	61.7

** refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat

Inflation trends were largely driven by food and international commodity prices. The inflation rate was decelerating in the last few years, reaching negative levels in 2014. The trend reversed in 2015 and inflation increased to 1.4 % as a result of rising prices for services (in particular accommodation and restaurants) and food. Since March 2016 inflation returned into negative territory driven by a new decline in fuel and food prices. In the first seven months of 2016, the inflation rate remained flat.

The fiscal position deteriorated and poses risks to macroeconomic stability. After several years of fiscal consolidation efforts, the budget deficit was reduced to 3 % of GDP in 2014, compared with 7 % two years before. However, the deficit surged again in 2015, reaching 7.3 % of GDP, considerably exceeding the target of 6.6 %. The substantial overrun resulted from the unplanned repayment of arrears related to utilities, pension rights, and the unfavourable resolution of several court cases against the state. Consequently, public debt rose to 64.1 % of GDP at the end of 2015, exceeding the fiscal rule's mandatory ceiling of 60 % and legally compelling the government to prepare a plan to reduce the debt under this limit within five years. However, such a plan was postponed until the elections in October.

ERP policy guidance: Stabilise the debt-to-GDP ratio net of debt related to capital investments already underway in 2016, and then reduce it over the remainder of the programme period.

The execution of the 2016 budget is marked by poor planning. The 2016 budget originally planned for a deficit of 7.15 % of GDP, projecting the financing needs for the Bar-Boljare highway and increases in pensions and public sector wages. However, the budget plan was rapidly obsolete due to the unplanned deficit of the healthcare fund, the postponement of capital investments, and the introduction of life-long benefits for mothers with three or more children. In the first half of 2016, budget revenues increased by 7.7 % y-o-y. However, current expenditure rose faster (by 9.6 % y-o-y), resulting in a central government deficit of 2.9 % of GDP. Nonetheless, the cash-basis budget fails to reflect all budget commitments on time, and therefore remains subject to revision. In June 2016, the public debt -including municipalities- totalled 64.3 % of GDP.

ERP policy guidance: Take immediate measures to restrain current spending, including on pensions and the public sector wage bill. To generate budgetary savings and improve revenue collection, conduct a comprehensive review of tax expenditure as well as exemptions, and implement tax increase in a growth-friendly manner.

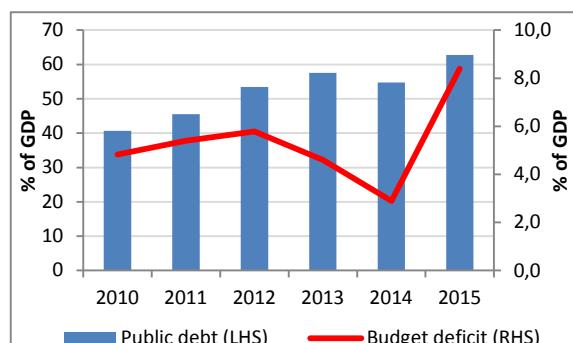
In light of the country's monetary regime, the fiscal stance has not been appropriate. Fiscal policy has been loosened since 2015, when public current spending increased significantly while revenues underperformed. High budget deficits and a fast growing public debt would have required urgent fiscal consolidation measures and a credible public debt management plan. However, such measures have not been taken so far.

Functioning of product markets

Business environment

The business environment recorded some improvement, but there is room for further progress. Efforts were made to enhance the protection of property rights, streamline legal and administrative procedures, and reduce backlogs at government offices. In 2015, the number of new companies registered was 4 113, similar to the previous two years. Companies can be partially registered online, although payments still need to be done in person. Cadastral records are available online, covering most of the country, but information is still problematic for some 7 % of rural area's territory. Users complain that the cadastre is not always updated, in particular with respect to encumbrances. In 2015, the average registration time of property transaction was 8 days, compared to 25 days in 2008, and the average time to issue a construction permit was reduced to 33 days at municipal level or 49 days at central level, down from 6 months in 2008.

Graph 12: Montenegro fiscal developments



The number of enforcement cases in the courts has been reduced since the introduction of the bailiff system, but is still considerable. In 2015, the collection rate of bailiffs was 21 %, solving 30 % of received cases. This represents good annual progress. However, predicting the outcome of judicial proceedings can be difficult due to the variability in speed and problems of consistency in case-law. Court orders are not always enforced or followed up. However, most bankruptcy liquidation proceedings – unless disputes arise – are completed in less than a year, compared to 18 to 30 months in the past. The informal economy remains large. In 2014, its size was estimated at 24.5 % of GDP¹, and it is considered as a major obstacle for conducting business. Corruption continues to be a serious concern, negatively affecting the business environment. Intensified efforts are needed to strengthen the rule of law to ensure that regulatory improvements translate into an improved investment climate.

State influence on product markets

The level of subsidies remains modest, but most of the state aid was allocated to one company (Montenegro Airlines). In 2015, the general government budget provided for a modest allocation of state aid of 0.6 % of GDP for subsidies (down from 0.8 % of GDP a year before), plus an additional 0.3 % of GDP for new state guarantees. However, overall state subsidies and recapitalisation of the national airways represented 1.6 % of GDP. The government expressed its commitment to stop providing state aid to the company as of 2016. Following the introduction in 2015 of tax exemptions to attract new investments in priority sectors, the number of construction permits for 4-star hotels is estimated to have increased by 140 %. However, this kind of incentive requires a comprehensive review to make sure it does neither hinder competition nor public finances.

Privatisation and restructuring

The privatisation process is quite advanced. State ownership in the economy is basically reduced to public utilities, some transport companies (i.e. the railways, one airline and four merchant ships), the postal services and some other companies. Overall, state-owned enterprises represent a small part of total employment. After being liquidated and sold to new owners, state support to the metal industry ended. The new aluminium and steel companies are currently going through a process of restructuring. In April 2016, the aluminium company terminated its dependence on the public local power supply, and started importing its electricity instead. The restructuring of the formerly state-owned Adriatic Shipyard in Bijela advanced slowly through the concession or sales of its different parts. In September 2016, the construction contract for replacing the state-owned old thermal power plant by a new one was signed, but it would not be operational before 2020. The difficult financial situation of the state-run Montenegro Airlines requires a comprehensive restructuring of the company. As a first step the company concluded a cooperation agreement with Air Serbia in August 2016, while continuing the negotiations to also establish a strategic partnership programme with the Arab Emirates national airline. Management of the bankrupt Ulcinj saltworks was taken for a second year in a row by the National Parks of Montenegro with the objective of revitalizing salt production.

Functioning of the financial market

Financial stability

Although stable, the banking system suffers from low profitability. Three new banks have started operating since mid-2015, raising the total number of banks in the country to 15. There is a significant degree of concentration, with the five largest banks accounting for almost two-thirds of total assets. The sector is largely dominated by foreign banks (80 % of share capital). In June 2016, the aggregated capital adequacy ratio was 16.6 %, clearly above the minimum requirement of 10 %. However, the large dependence on foreign financing makes banks vulnerable to funding cost volatility. The share of non-performing loans (NPLs) dropped to 11.7 % in 2015 from 16.5 % a year earlier, with a provision coverage ratio of 72.6 %. Overall, although the crisis preparedness and management framework of the

¹ UNDP National Human Development Report 2016.

financial system appear well developed, low bank profitability remains a source of vulnerability for some domestic banks, requiring further development of the macroprudential framework (*See chapter 9 - Financial services*).

Access to finance

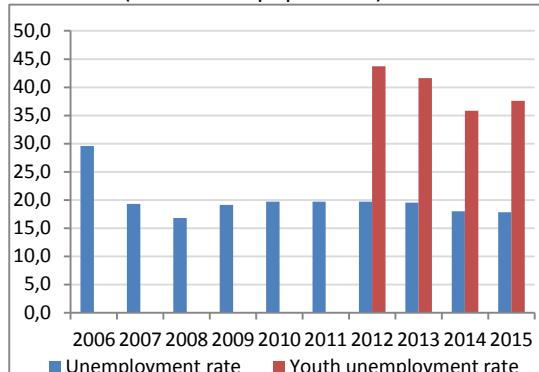
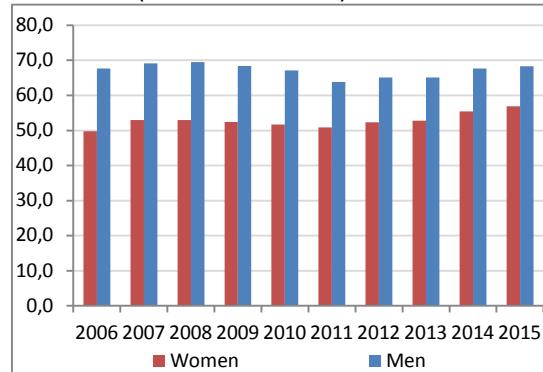
Lending to the private sector has not yet recovered to the pre-crisis level. The low credit growth is the result of risk aversion among banks due to the high level of NPLs but also poor investment readiness and financial literacy among SMEs. In the first half of 2016, corporate lending recorded some improvement, growing by 3 % y-o-y (compared to 0.7 % a year before), while household loans grew by 5.4 % y-o-y. The reduction of non-performing loans allowed some reduction of financing costs for domestic companies. In June 2016, the average effective interest rate on new loans was 6.72 %, and 6.35 % for business loans, the latter down from 7.82 % a year before.

ERP policy guidance: Develop a comprehensive strategy to further foster the disposal of non-performing loans by banks, including participation by all relevant stakeholders, while establishing a bank lending survey to better gauge underlying credit dynamics.

The non-bank financial sector is small. In 2015, the market capitalisation of Montenegro Stock Exchange was significant, totalling 82 % of GDP, but its turnover was very low, at just 1.8 % of GDP. The insurance market is also modest, accounting for 2 % of GDP; a similar size as domestic micro-credit institutions. Leasing accounts for less than 1 % of GDP. Corporate lending of the state-run Investment Development Fund (IDF) represents 3 % of GDP, compared to 28 % of GDP from commercial banks.

Functioning of the labour market

The unemployment rate is high, hindered by poor labour mobility, labour market rigidities and a skills mismatch. The strong demand for foreign labour contrasts with the low mobility of the local workforce. The working population (15-64) activity rate in Montenegro still is 12 percentage points lower than the average in the EU, even if it has increased over the past five years from 57.3 % in 2011 to 62.6 % in 2015, and to 63.6 % in the first half of 2016. Meanwhile, the unemployment rate declined modestly, from 19.7 % in 2011 down to 17.7 % in June 2016. However, the unemployment and participation rates of women (17.3 % and 56.6 %) remain lower than for men (18.0 % and 70.6 %). The gender imbalance worsened as regulatory changes in the social care system, like the life-long benefits for mothers of at least three children, provided disincentives for women participation. More than 15 000 women have already applied for these lifelong benefits, effectively pushing many of them out of the labour market. In the second quarter of 2016, women labour force declined by 2.6 % y-o-y, while men's participation increased by 1.2 %. The unemployment rate of young people (15-24 years old) is also very high at around 35.5 % in the second quarter of 2016.

Graph 13: Unemployment in Montenegro
(% of Active population)**Graph 14: Participation rates in Montenegro**
(% of Labour Force)

Active labour market policies continue to be under-funded, with the focus on young graduates and seasonal workers. Long-term unemployed women and young people in particular could benefit from reductions in work disincentives, like the benefits for mothers mentioned above or the introduction of active labour market policy instruments.

ERP policy guidance: Prolong working lives and reduce disincentives to work through strengthening the link between activation measures and social assistance, in order to improve the labour market participation of the long-term unemployed, women and youth. Implement strategies to align education and skills policies with labour market needs.

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

Montenegro is **moderately prepared** in its capacity to cope with competitive pressure and market forces within the Union. **Some progress** was achieved in improving the quality of infrastructure, the energy market and the digitalisation of the economy. SMEs support is modest but gradually developing. However, substantial efforts are still required to develop human capital and a competitive export-oriented industry.

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

- ensuring effective, efficient and independent regulatory and safety authorities to implement the full opening of rail and energy markets;
- facilitating provision and range of financial and non-financial support services for SMEs with a view to fostering participation in global value chains;
- implementing strategies to align education and skills policies with labour market needs by improving the quality of education and equipping students with better basic and transversal skills.

Education and innovation

The school-to-work transition is not efficient for most youth. It takes nearly two years on average to attain a first job deemed to be either stable or satisfactory. Public spending on education represents 4.2 % of GDP, compared to 5.3 % average in the EU. Early childcare and pre-schooling (0-5 years) enrolment rates are low (at 38 %, and well below the EU target of 95 % by 2020) in contrast with the high enrolment rates in education at primary and secondary levels at 98 % and 85 %, respectively. Enrolment at tertiary level is relatively high at 35 %. However, Montenegrin students' poor average

score of 31/100 in the last OECD's PISA tests for reading, science and mathematics underlines the need for improving the quality of basic education.

The stagnation since 2011 of the unemployment rate of secondary VET graduates (at around 18 %), suggests that the effectiveness of the VET system could also be further improved and the enrolment rates in VET reduced. Meanwhile, the provision of in-company practical training in real work environment is still at an initial stage, with less than 2 % of employees participating in some sort of training or skills development. In 2013, only 23.7 % of companies offered formal training to their employees.

Overall, although educational attainment has increased significantly in a generation, the number of graduates from higher education is not easily absorbed into the limited number of available jobs. In addition, as pointed out in a recent EU funded study, both employers and graduates believe that the education institutions do not equip students with key soft skills, such as problem solving, organisational, decision-making, foreign languages, etc., which are important for employability. The educational provision in VET and higher education sectors should reflect and reinforce the country's economic development strategies.

Considerable efforts are also required to increase the level of investment in research and innovation, particularly from the private sector. Investment in research is modest. In 2014, total investment on research and development amounted to 0.36 % of GDP, and of this, only 0.14 % came from private sector. The construction of the multi-purpose innovation and entrepreneurship centre 'Tehnopolis' was completed and public tenders for selection of 14 entrepreneur tenants finalised. The centre officially opened on 17 September.

Physical capital and quality of infrastructure

Some progress was made in developing transport and energy infrastructure. Ground transport suffers from bottlenecks and a lack of cross-border roads is hindering trade and tourism. After one year of preparatory works, the highway priority section to connect the port of Bar with the Serbian border started in 2016. The main rail line Bar-Belgrade is being overhauled to increase the average speed of trains by 60 %. Meanwhile, there has been a steady progress in liberalizing the railway sector in Montenegro. The rail market was legally opened in 2014 and capacity allocation process implemented, but further efforts are needed to improve railway safety and interoperability, including ensuring sufficient capacity for and the independence of the rail regulatory body and rail safety authority. Air fares are rather high and low-cost carriers offer relatively few routes to Montenegro.

ERP policy guidance: Ensure effective, efficient and independent regulatory and safety authorities to implement the full opening of rail and energy markets.

In October 2015 a digital system (VTMIS) for maritime traffic control was established. The electric power system is being upgraded with new transmission lines, several small hydropower plants and the construction of the first wind-farms. However, the construction of the new thermal plant was delayed. Improved regional cooperation is supported by the construction of a submarine cable (to become operational in 2019), connecting Montenegro and Italy, with extensions towards Serbia and Bosnia and Herzegovina. In 2016, the unbundling of the power utility EPCG enabled new suppliers to compete in the local electricity market. Development of an offshore oil and gas industry is at an incipient stage. However, infrastructure investments can be better embedded in wider sector policies, including regulatory measures.

The digitalisation of the economy continues. The penetration rate of fixed broadband internet expands gradually, reaching 60.3 % in June 2016 compared to 50 % five years before. In 2015, 94.3 % of surveyed enterprises reported on the use of computers and the internet in their activities. At 170 %, Montenegro has one of the highest mobile phone penetration rates in Europe as well as world-

wide. Montenegro's e-government portal is quite advanced. Online banking and e-commerce are rising and have a large potential for further expansion.

Sectoral and enterprise structures

Services are the main engine of growth and employment. Services account for 72.6 % of total gross value added, compared with 12.9 % for the industrial sector, 9.8 % for agriculture and 4.6 % for construction. The trend in the last years reflects a continuous growth of services' gross value added. The development of services is also reflected in the share of jobs occupied by young people. The large majority of youth (88 %) work in services, and in the case of female youth this percentage reaches 95 %. By contrast, young workers in industry and agriculture represent 4 % and 1 %, respectively.

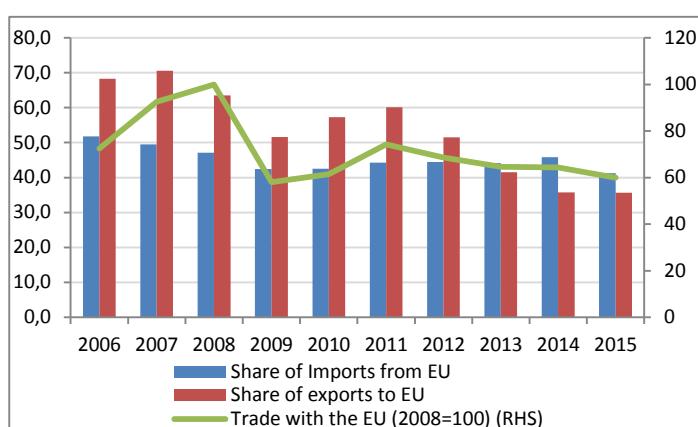
Government support to SMEs aims to facilitate access to finance and to foster investment. SMEs represent 99 % of total firms and generate 75 % of value added as well as 82 % of employment. Access to finance is one of the major challenges for SMEs. The IDF channels the largest portion of public sector support for SMEs through credit lines for start-ups and financing programmes. However, the IDF discontinued funding for credit guarantee schemes. The government is implementing a pilot project to support the modernisation of industry by offering favourable financing conditions.

ERP policy guidance: Continue to facilitate the provision and range of financial and non-financial support services for SMEs with a view to foster participation in global value chains. Support the development of the private consultancy market.

Economic integration with the EU and price competitiveness

The EU and CEFTA are Montenegro's main trading partners. Total trade with the EU has gradually deepened in the last five years. In the first half of 2016, trade with the EU accounted for 44.8 % of Montenegro's exports and 49.2 % of its imports, followed by trade with CEFTA, representing 40.7 % of exports and 29.3 % of imports. In March 2016, Montenegro ratified the new WTO Trade Facilitation Agreement to facilitate the movement of goods and customs clearance procedures. Financial integration with the EU is also high, accounting for 74 % of foreign assets in local banks and 63 % of the FDI in 2015.

Graph 15: Montenegro trade integration with the EU



Montenegro needs to improve its export performance.

Montenegro is a small and open economy. In 2015, the total value of exports of goods and services totalled 103.4 % of GDP. Yet, the country has a small manufacturing base largely concentrated on commodities. Products are predominantly of low technological and value added content. Moreover, the geographical location – distant from major international transit routes and Europe's industrial and production networks. The

centres – excludes Montenegro from international transport and the competitiveness of domestic companies is poor, with a value added per employee of around EUR 11 000, compared to EUR 42 000 on average in the EU.

3.3. CONCLUSIONS

As regards **economic criteria**, Montenegro is moderately prepared in developing a functioning market economy. Some progress was made to strengthen the functioning of the financial and labour markets, as well as on improving the business environment. Investments in infrastructure and tourism support economic activity. However, rapidly rising public debt and high fiscal deficits, together with high external imbalances and high unemployment are of concern. The combined effects of large-scale public infrastructure investments and several new expensive social expenditure programmes challenge fiscal sustainability. Immediate corrective measures are required, as called for by the ERP policy guidance. Other problems to be tackled include high external imbalances and low labour market participation and still low credit growth amid high impaired bank loans.

Montenegro is moderately prepared in its capacity to cope with competitive pressure and market forces within the Union. Some progress was achieved in improving the quality of infrastructure, the energy market and the digitalisation of the economy. SMEs support is modest but developing gradually. However, substantial efforts are still required to develop human capital and a competitive export-oriented industry.

4. SERBIA

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

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. 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.

4.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Serbia is **moderately prepared** in developing a functioning market economy. **Good progress** was made to address some of the policy weaknesses, in particular with regard to the budget deficit. Growth prospects have improved and domestic and external imbalances were reduced. Price stability has been preserved. The restructuring of publicly-owned enterprises has advanced.

However, government debt is still very high. Credit activity is recovering but the high level of non-performing loans remains an issue. Unemployment is very high, particularly among youth. The private sector is underdeveloped and hampered by weaknesses in the rule of law.

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

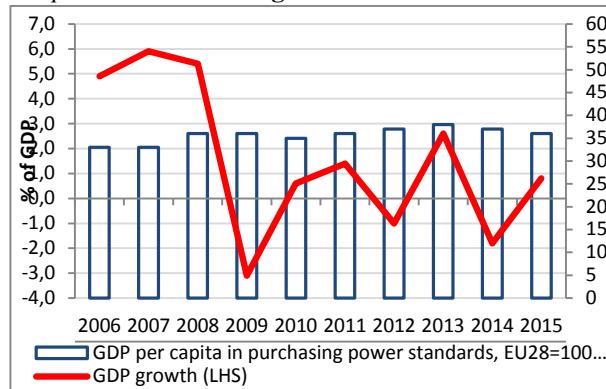
- further lowering the budget deficit and reducing the high public debt level;
- continuing the restructuring and privatisation of state-owned enterprises and addressing the non-performing loans (NPLs);
- improving revenue collection in a systematic and business-friendly way by implementing the tax administration transformation programme and fighting the informal economy.

Economic governance

The government remained committed to creating a functioning market economy. It continued implementing the Stand-By Arrangement with the International Monetary Fund (IMF). However, the Economic Reform Programme policy guidance has only been partially implemented. Strong fiscal consolidation measures led to a significant reduction of the very high budget deficit and provided room to lower interest rates. The restructuring and resolution of state-owned enterprises and the public administration reform advanced. Financial stability was preserved and the business environment improved.

Macroeconomic stability

Graph 16: Serbia GDP growth



Growth fundamentals and prospects have improved. The rebound of economic activity was supported by base effects, low oil prices, and increased confidence as a result of implemented reforms and strong fiscal consolidation. GDP growth was modest in 2015 before accelerating strongly to 2.9 % in the first half of 2016. Although the economy is still close to its pre-crisis level, there is a new growth momentum based on sounder fundamentals. It is driven by a robust and broad-based expansion of exports and investment. The new investment cycle that started last year should further support the rebalancing of the economy. The income gap with the EU remained broadly unchanged: in 2015, per capita GDP in purchasing power standards stood at 36 % of the EU average.

Surging exports have reduced external imbalances. Serbia's solid export performance continued unabated and import coverage of goods and services increased from around two-thirds 5 years ago to close to 90 % in early 2016. As a result, the trade and current account deficits were markedly reduced. In the four quarters to June 2016, the current account deficit fell to around 4 % of GDP, compared with an average of close to 8 % over the last 5 years, and was fully covered by net Foreign Direct Investment (FDI). Moreover, FDI inflows, which picked up already last year, have been broad-based, with a significant share going into manufacturing and tradable sectors. The level of external debt remains high and makes the economy vulnerable to external shocks. The debt ratio has crept up to around 80 % of GDP but, in view of shrinking external imbalances and a favourable term structure, does not raise immediate concerns. Over the last 5 years, the official foreign exchange reserves remained relatively high.

Table 4.1:
Serbia - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	1.4	-1.0	2.6	-1.8	0.8	2.9
Private consumption	Ann. % ch	0.9	-2.1	-0.4	-1.3	0.4	1.1
Gross fixed capital formation	Ann. % ch	4.6	13.2	-12.0	-3.6	5.6	6.7
Unemployment (>15 years old)	rate %	23.0	23.9	22.1	19.2	17.7	17.1
Employment (registered)	Ann. % ch	-6.0	-1.1	3.7	10.1	0.6	4.7
Wages (average, net real)	Ann. % ch	11.1	9.0	5.7	1.1	-0.4	4.4
Current account balance**	% of GDP	-10.9	-11.6	-6.1	-6.0	-4.7	-4.4
Direct investment (FDI, net)**	% of GDP	5.5	2.2	3.9	3.7	5.4	5.7
CPI (end of period)	Ann. % ch	7.0	12.2	2.2	1.7	1.5	0.3
Exchange rate RSD/EUR	Value	101.96	113.01	113.09	117.25	120.76	122.93
General government balance	% of GDP	-4.8	-6.8	-5.5	-6.6	-3.7	-1.0
General government debt	% of GDP	44.2	55.9	58.8	68.3	74.1	72.9

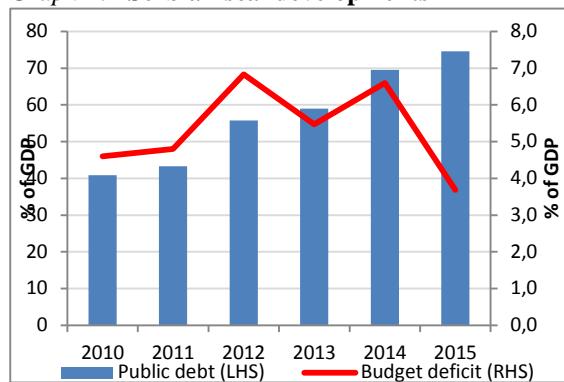
** refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat

Monetary policy supported growth. Inflation has been persistently below the central bank target of 4 % ± 1.5 percentage points since February 2014. Price stability has been facilitated by a long period of low inflation in major trading partners and, in particular, by declining commodity prices, weak domestic demand, and a policy of maintaining a generally stable exchange rate. The low inflationary pressure and strong fiscal consolidation helped reduce inflation expectations and supported further reductions in the key policy rate of the central bank from 5 % in September 2015 to 4 % in July 2016. In an effort to improve lending conditions and spur credit growth, the central bank also gradually cut the foreign currency reserve requirement ratio.

Fiscal consolidation has been very strong. After years of very high budget imbalances, the budget deficit fell from 6.6 % of GDP in 2014 to 3.7 % of GDP in 2015. Public wage and pension cuts, implemented at the end of 2014, and better-than-expected collection of tax revenue contributed to a significant structural adjustment. In addition, the deficit reduction was also supported by one-off revenue. The good budget performance allowed for a partial reversal of wage and pension cuts as well as unplanned one-off payments by the end of last year. The strong revenue growth continued in 2016 and led to a small budget surplus by the end of August, despite a 36 % increase in capital expenditure. In view of this, the restrained spending on wages and pensions, and some one-off receipts, the 2016 budget deficit is, therefore, likely to be significantly lower than the originally planned 4 % of GDP.

Graph 17: Serbia fiscal developments



Fiscal consolidation needs to be sustained. Despite an impressive deficit reduction, fiscal imbalances and risks remain high and fiscally important structural reforms have been only partially implemented. Interest payments are significant and the share of mandatory expenditure is still too large to allow for a sizeable shift towards a more growth-enhancing pattern of spending. In order to put public finances on a sound footing, the consolidation drive has to be supported by maintaining strict control over current expenditure and by further advancing public finance reforms and the restructuring of state-owned enterprises.

ERP policy guidance: Further strengthen fiscal consolidation by using any excess revenue and current expenditure savings, and take additional measures, if needed, in order to achieve a primary surplus in 2016 and reduce overall budget deficits in the following years.

There are ongoing efforts to strengthen the budgetary framework and governance. As fiscal consolidation advances, the importance of addressing institutional deficiencies is growing. In late 2015, the government adopted a Public Finance Management reform programme and action plan, which should now be implemented. The public administration reform has advanced. Dedicated efforts are also being made to strengthen the tax administration and reform local government finance. The Fiscal Council remained a prominent institution, supporting domestic debates on fiscal policy. However, the fiscal responsibility framework and, in particular the system of fiscal rules, is weak and needs to be strengthened.

ERP policy guidance: Support fiscal consolidation by taking steps to find a sustainable resolution of the remaining state-owned enterprises and continuing the organisational and financial restructuring of large utility companies. Advance the reform of the public administration as envisaged. Further improve revenue collection in a systematic and business-friendly way by implementing the tax administration transformation programme.

The macroeconomic policy mix has been appropriate. The economy is still facing significant challenges but the authorities' reform-oriented policy stance has begun to bear fruit through improved growth prospects, a better sovereign credit rating and an improved business environment. The combination of restrictive fiscal policy and accommodative monetary policy stance has proven successful. Macroeconomic stability improved as a result and the economy returned to growth earlier than expected.

Functioning of product markets

Business environment

Steps were taken to further facilitate market entry procedures. The procedure of registering business entities was improved, including by making it possible to apply for incorporation and VAT registration at the same time. Following the simplification of the process of issuing construction permits last year, a new electronic permitting system became operational at the beginning of 2016.

The system allows for faster processing of applications for construction — in the first half of 2016 the number of building permits issued increased by 12.2 % and the anticipated value of works is 50 % higher in comparison with the same period the year before.

ERP policy guidance: Improve the business environment and promote private investment by developing a more transparent and less burdensome system of para-fiscal charges, putting in place a guarantee scheme for loans to SMEs and re-launching the ‘regulatory guillotine’.

The institutional and regulatory environment remains weak. Important laws continue to be adopted by emergency procedure, without proper consultations with interested parties, and there are delays in the adoption of secondary legislation. Courts are burdened with a substantial number of unresolved cases. Property restitution progressed, with about half of all claims being resolved. The informal economy is estimated at around 20-30 % of GDP and leads to losses of budget revenue, a lack of labour protection and, along with corruption, is a major obstacle to fair competition. In December 2015, the government adopted a national programme for countering the shadow economy. The high number of loosely regulated non-tax fiscal and para-fiscal charges, both at state and local government level, represents a costly burden on businesses.

State influence on product markets

The State presence in the economy and the level of state aid are high. The share of administered prices remains broadly unchanged at around 19 % of the consumer price index basket. The State has not issued new guarantees for liquidity support to SOEs or guarantees to companies from the portfolio of the Privatisation Agency. The government also committed itself not to give implicit guarantees in the future. However, in the context of restructuring SOEs, it continued taking over debt of some of these enterprises that were already beneficiaries of previous guarantees. The administrative capacity to manage subsidies at local and central level remains weak. In many cases, State aid continues to be granted to unprofitable public companies or in a non-transparent manner. Investment aid, in particular, is not granted on the basis of predictable criteria in line with the EU and SAA state aid rules. State support should be redirected towards horizontal objectives, such as support to SMEs and research and development.

Privatisation and restructuring

Bankruptcy and privatisation challenges persist. Following amendments to the law on privatisation, the Privatisation Agency ceased to exist in February 2016. Its activities were transferred to other institutions. By September 2016, the status of most of the companies in the portfolio of the Privatisation Agency has been solved through sale or bankruptcy procedures. The protection of companies of strategic importance from forcible collection of debts and bankruptcy was lifted in the beginning of June. With a few exceptions, like the sale of assets of the Smederevo steel mill, the resolution of these companies remains a challenge.

The restructuring of large public utilities has advanced. In view of the significant economic and fiscal impact, improving their operational and financial performance remains a priority. In February, the government adopted a financial consolidation plan of Srbiagas. Although the payment discipline of the company’s major clients has improved recently, obligations from past arrears are high and

financial restructuring is still due. First steps to reorganise Elektroprivreda Srbije, the state-owned power utility, were taken in 2015. Further measures, envisaged in its financial restructuring plan, to reduce costs, including staff reduction, and increase revenue have been implemented or are in the pipeline. In October 2015, the government adopted a comprehensive restructuring plan for the Serbian Railways until 2020, focusing on assets, network and staff reorganisation. Major steps were taken towards implementing this plan.

Functioning of the financial market

Financial stability

Reducing the high level of non-performing loans remains an important challenge.

The banking sector maintained a strong liquidity position and capital adequacy ratio. The special diagnostic study conducted by the central bank last year did not identify capital shortfalls for any of the participating banks, representing 88 % of total banking system assets.

However, despite declining in the first half of 2016, non-performing loans (NPLs) stood high, at close to 20 %, and remain a significant burden for banks. Therefore, a continuous implementation of the NPL resolution strategy, adopted in 2015, is much needed. The profitability of the banking sector improved, although some of the small banks recorded losses. Despite increased dinarisation of household loans, the overall deposit and loan euroisation is widespread and represents a key financial stability risk. A privatisation advisor was selected for the second largest bank. Further measures, including also actions on the remaining small state-owned banks and the restructuring of other financial institutions, are needed in order to reduce risks.

ERP policy guidance: Continue to address risks to financial stability and the real economy by following-up on the NPL action plans which have been adopted, reinforcing the strategy already in place to promote the use of the local currency ('dinarisation strategy') in the financial system and shedding increased light on the asset quality of smaller banks that were not covered by the special diagnostic studies. Throughout this process, the central bank's monetary policy stance may remain accommodative insofar as both inflation expectations remain anchored and a favourable fiscal consolidation path is maintained.

Access to finance

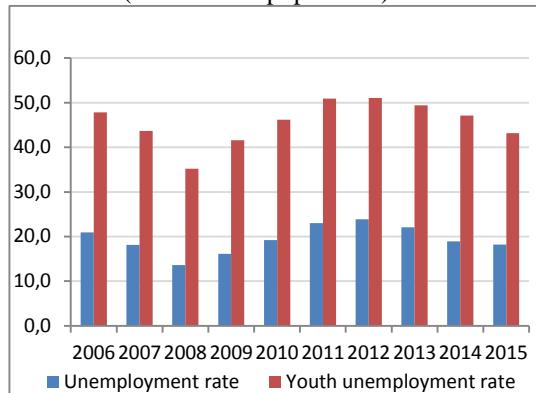
Lending activity is picking up but needs to be managed carefully. The financial system is dominated by commercial banks, mostly foreign-owned, holding more than 90 % of all assets. State control of key entities in both the banking and insurance sectors remained unchanged. Commercial bank loans were broadly stagnant over the last few years at around 47 % of GDP but started to expand noticeably in 2016. Reduced interest rates and accelerating economic activity have been instrumental in reviving lending activity. Credit to households expanded steadily in the last few years and accelerated further in 2016. After a prolonged period of decline, lending to companies gained momentum as well. However, the credit expansion would need to be managed carefully in order to avoid excesses and accumulation of new vulnerabilities.

Functioning of the labour market

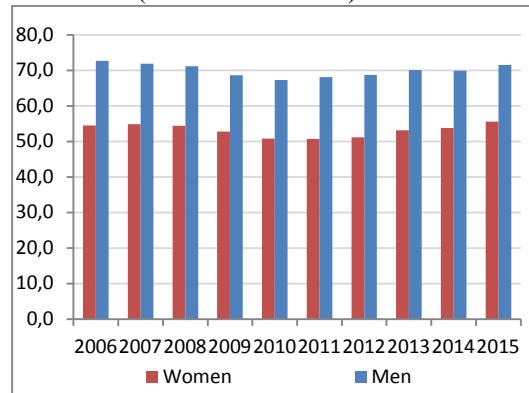
Labour market conditions improved but unemployment remains very high. The employment rate increased only marginally in 2015. Registered private sector jobs rose strongly by close to 10 % due to stricter labour inspection, while the public sector shed some 34,000 jobs. The unemployment rate fell to 17.7 %. Labour market indicators improved further in 2016, to a large extent driven by rising informal, in particular agricultural, employment. Although in decline, unemployment is still particularly high among young people — around 40 % of youth has no job and close to one in four is not in employment, education or training. Women's position in the labour market did not change and is characterised by significantly lower activity and employment rates compared to men.

Graph 18: Unemployment in Serbia

(% of Active population)

**Graph 19: Participation rates in Serbia**

(% of Labour Force)



Job creation continued to be impeded by weak labour demand and structural obstacles. Labour demand, although on the rise, is far below its pre-crisis levels. Amendments to the labour law, adopted two years ago, increased labour market flexibility.

However, the relatively high social contribution burden, in particular on low incomes, impedes job creation and fuels labour market duality. More than 85 % of all unemployed have a medium or high level of education, pointing to considerable gaps between acquired skills and labour market demand. Brain drain remains a major challenge. The National employment service is being strengthened and the budget for active labour market policies was increased, with a special focus on young people, redundant workers and the long-term unemployed.

ERP policy guidance: Step up the provision of targeted active labour market policies to facilitate in particular the reintegration of workers made redundant in the resolution of state-owned enterprises and public administration rightsizing. Increase the capacity of the National Employment Services to roll out such measures to larger numbers of beneficiaries.

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

Serbia is **moderately prepared** to cope with competitive pressure and market forces within the Union. **Some progress** was made concerning support to SMEs and entrepreneurship. Public and private investments increased.

However, the quality, equality, and relevance of education and training do not fully match societal needs. The level of investment activity is still below the economy's needs. SMEs face a number of challenges, including an unpredictable business environment, a high level of para-fiscal charges, and difficult and costly access to finance.

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

- improving the quality of the education system;
- stimulating private investments and improving prioritisation and management of public infrastructure projects;
- better regulating and reducing the scope of para-fiscal charges, in particular for SMEs.

Education and innovation

The worsening demographic situation and weak education outcomes demand increased focus on human capital policies. Serbia's population is ageing and shrinking by around 0.5 % per year. Public spending on education is comparable to that of EU countries, but outcomes in terms of skills and key competences are weaker. This is manifested by below-average PISA¹ test scores showing that around one-third of the population is functionally illiterate. Serbia ranked below all EU Member States in the 2016 World Economic Forum human capital index, with particularly weak results in the 15-24 age group. Although the country has a relatively good scientific base, the level of investment in research is less than 1 % of GDP and cooperation between the public and private sector is weak and not systematically supported.

The quality, equality, and relevance of education and training have to be improved in order to better match societal needs. Both employers and graduates believe that the education institutions do not equip students with key soft skills, such as problem solving, organisational, decision-making. The national strategy and action plan for education development aims to address the outdated curricula and obsolete teaching methods. On the basis of existing qualification frameworks for vocational and higher education, an integrated national qualification framework for lifelong learning has been developed and is under consultation with relevant national bodies. It should be linked with steps for a progressive reform of the education system at all levels, improving the level of basic skills acquired by students. Pre-primary education enrolment is below the EU average at around 60 % for children aged 3 and above and just 17 % for children aged below 3.

Physical capital and quality of infrastructure

Investments increased but are still below the economy's needs. Years of underinvestment have taken their toll and, despite a strong pick-up in both public and private investment activity that started last year, the share of total investment stood at just 18 % of GDP in 2015. Work on major transport corridors intensified but, in view of the poor state of infrastructure, there is a clear need to further increase government investment. Importantly, foreign direct investment rose markedly to 5.4 % of GDP in 2015 and was largely channelled into tradable sectors like manufacturing, thus improving competitiveness and increasing the production and export base. However, there is still significant room to attract new FDI as Serbia lags behind peer countries in terms of cumulative FDI per capita.

ERP policy guidance: Address the under-execution of public capital expenditure by improving its prioritisation and management; as a priority, make significant progress in the preparation of the construction of the Bulgaria-Serbia gas interconnector project and finish road works on Corridor X by end of 2017.

There is an untapped potential to facilitate investment via connectivity reform measures in the energy and transport sector. Project planning, preparation and coordination needs to be improved, building upon existing structures like the National Investment Committee and the Single Project Pipeline. Given limited fiscal space, careful consideration should be given to prioritising and implementing projects with clear economic returns. All investment could benefit from improving the legal and regulatory framework. The transport and energy sectors require improvements in traffic management, energy efficiency and diversification, maintenance, and road safety.

The information and communication technology infrastructure has expanded over recent years. Almost two-thirds of households have internet access at home. Public services offered via e-government are slowly expanding. The number of their active users also continued increasing.

¹ OCED's Programme for International Student Assessment

Sectoral and enterprise structure

The structure of the economy remained broadly unchanged. Services still play a major role with a share close to 50 % of GDP. In 2015, industry and mining have increased slightly their weight, recovering from the floods the year before, and are firmly above 20 % of GDP. In line with the strong investment growth, the construction sector is booming, approaching its pre-crisis levels. Agriculture is the only sector which has seen its share in GDP more or less steadily decline over the last few years. This decline was accompanied by a drop in employment in 2015. Nevertheless, almost one out of every five employed people is still in agriculture. Employment in industry and construction remained broadly stable, while employment in services increased markedly, likely due to better recording and measures taken to reduce the informal economy.

Small and medium enterprises are the backbone of the economy. SMEs contribute about half of the value added and account for around 70 % of employment in the ‘non-financial business economy’. Their role is particularly prominent in services like construction, retail and tourism. Although SMEs’ share in manufacturing has been above 40 % in the last few years, they have not been able to recover to their pre-crisis positions. SMEs face a number of challenges, including an unpredictable business environment, a high level of para-fiscal charges, and difficult and costly access to finance, especially when compared with large and state-owned enterprises. The government recently adopted the ‘Year of Entrepreneurship 2016’ programme with the aim to provide financial and non-financial support to businesses.

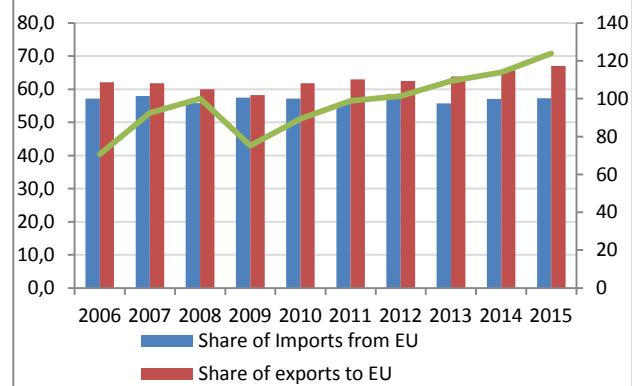
Economic integration with the EU and price competitiveness

There is a potential to further increase economic integration with the EU market. Trade openness increased, surpassing 100 % of GDP, but is still below the level of peer economies. The national quality infrastructure still does not fully support trading operators. The EU is the country’s main trading partner by far, accounting for 63.6 % of total exports and 62.3 % of total imports of goods. Serbia’s trade with CEFTA followed with an 11.5 % share in overall trade but was much stronger on the export side, which is three times the size of imports.

The EU continued to be the main source of foreign investment too, with a share in net FDI of 82 % in 2015 and more than three-quarters of the cumulative FDI stock. Better services could be offered to support the internationalisation of companies, in particular SMEs, and bring domestic and foreign companies together.

After depreciating slightly in 2014, the dinar real effective exchange rate remained broadly stable. Serbia’s non-price competitiveness, however, improved significantly due to reforms to improve the business environment and a marked increase in FDI in the last few years.

Graph 20: Serbia trade integration with the EU



4.3. CONCLUSIONS

As regards the **economic criteria**, Serbia is moderately prepared in developing a functioning market economy. Good progress was made to address some of the policy weaknesses, in particular with regard to the budget deficit and restructuring of publicly-owned enterprises. Economic reforms have brought clear results in terms of growth prospects and reduction of domestic and external imbalances.

In view of the still high level of government debt, fiscal consolidation needs to be sustained. The restructuring of large state-owned utilities is still to be completed. Credit activity is recovering but the high level of non-performing loans remains an issue. Unemployment remains high, particularly among youth. Further expansion of the private sector is hampered by weaknesses in the rule of law.

Serbia is moderately prepared to cope with competitive pressure and market forces within the Union. Public and private investments increased, though the level of investment activity remains below the economy's needs. The quality, equality and relevance of education and training do not match societal needs. **Some progress** was made concerning support to SMEs and entrepreneurship but SMEs face a number of challenges, including an unpredictable business environment, a high level of para-fiscal charges, and difficult and costly access to finance.

5. TURKEY

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

The monitoring of these economic criteria should also be seen in the context of the central importance of economic governance in the enlargement process. 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 prepared 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** and can be considered a functioning market economy. Public finances are on a sustainable course. Economic growth strengthened last year, but is slowing again in 2016 while unemployment remains relatively high. The current account deficit has narrowed mainly as a result of the lower oil price. Nevertheless, the external deficit remains large and makes the Turkish economy vulnerable to financial uncertainty, changes in global investors' sentiment and political risks. The central bank cut interest rates even though inflation remained well above the official target. The business environment continued to deteriorate due to targeted actions against critical media, business people and political opponents through the active use of the tax authority, the financial crimes unit and courts. The implementation of structural reforms to improve the functioning of the markets for goods, services and labour has stalled. Overall, there was **backsliding**.

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

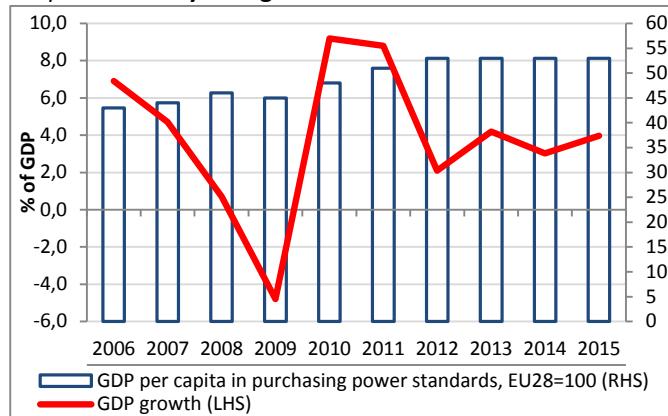
- promoting domestic saving, including through a sufficiently restrictive fiscal policy, in view of the persistently large current account deficit;
- making monetary policy more focused on the pursuit of price stability;
- improving the business environment by strengthening the rule of law, making it easier to start a business and strengthening competition.

Economic governance

Turkey has a functioning market economy, but the resolve to address underlying macroeconomic imbalances has been uneven. The recommendations from 12 May 2015 were only partially implemented. The government's Economic Reform Programme for 2016-2018 projects an overly optimistic macroeconomic scenario in which GDP growth strengthens while unemployment, inflation and the current account deficit decrease. The establishment of a Deputy PM post to oversee structural reforms was a positive development as it has the potential to improve the coordination of economic policy-making between government bodies. At the same time, targeted government actions against critical media, business people and political opponents through the active use of the tax authority, the financial crimes unit and courts, have had negative effects on the business climate. Uncertainty over the central bank's independence in carrying out monetary policy continued to the detriment of macroeconomic stability.

Macroeconomic stability

Graph 21: Turkey GDP growth



The Turkish economy has grown at an average annual rate of 3.7 % over the past three years. GDP growth increased gradually in 2015, with growth rates moving up from 2.5 % year-on-year in the first quarter to 5.7 % in the last quarter of the year. The annual GDP growth of 4.0 % was solely driven by domestic demand, particularly based on accelerating household consumption and public spending. Private investments remained relatively weak, while the contribution of net exports was negative. In 2016, GDP growth has

slowed to 3.1 % year-on-year in the second quarter as net exports continued to deteriorate and private investment activity weakened. The decline in foreign tourist visits (32 % year-on-year in the first eight months) has weighed heavily on economic activity in the third quarter. GDP per capita based on purchasing power parity remained unchanged in 2015 at 53 % of the EU average.

Effects of the failed coup attempt on the overall economic situation are still difficult to assess. After an initial sell-off, Turkish financial markets recovered, although not quite to the levels before 15 July. Industrial production and retail sales dropped sharply in July and some survey indicators declined. Restoring and maintaining investor confidence will in any case require the rule of law and independence of the judiciary to be respected.

Turkey's current account deficit has narrowed significantly, but remains relatively high. The deficit has declined from 7.7 % of GDP in 2013 to 4.5 % in 2015 as the lower oil price has reduced the energy import bill and the notoriously volatile gold trade has swung from deficit to surplus. The underlying deficit, however, has not improved. Excluding energy and gold, the current account actually deteriorated by 1.5 percentage points of GDP between 2014 and 2015.

Table 5.1:
Turkey - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	8.8	2.1	4.2	3.0	4.0	3.9
Private consumption	Ann. % ch	7.7	-0.5	5.1	1.4	4.8	6.2
Gross fixed capital formation	Ann. % ch	18.0	-2.7	4.4	-1.3	4.0	-0.3
Unemployment rate	%	9.0	8.3	8.9	10.1	10.4	10.2
Employment	Ann. % ch	6.6	3.1	2.8	1.6	2.8	3.2
Wages (hourly, manufacturing, index)	Ann. % ch	9.7	11.5	12.4	14.2	14.8	18.6
Current account balance**	% of GDP	-9.7	-6.1	-7.8	-5.9	-4.5	-4.2
Direct investment (FDI, net)**	% of GDP	2.1	1.7	1.5	1.6	2.4	2.1
CPI, average	Ann. % ch	6.5	8.9	7.5	8.9	7.7	7.8
Exchange rate TRY/EUR, average	Value	2.33	2.31	2.53	2.91	3.02	3.26
General government balance	% of GDP	-0.8	-0.3	-1.6	-1.5	-1.4	-0.1
General government debt	% of GDP	39.9	36.2	36.2	33.5	32.9	32.3*

** refers to a 4 quarters moving average. * Q1

Sources: Data Insight, Eurostat

The external deficit reflects a persistent shortfall of domestic saving requiring compensating inflows of foreign capital. Most capital inflows tend to be portfolio investments by foreign investors and foreign borrowing by Turkish banks. Foreign direct investment (FDI) has represented a relatively small proportion of the required capital inflow since the global financial crisis. In 2015, however, FDI covered 36.5 % of the current account deficit as a result of a number of large foreign investments in the financial sector. The dependence on volatile types of capital inflows makes the Turkish currency

and economy vulnerable to a sudden loss of investor confidence. Gross external debt as a percentage of GDP has edged higher, reaching 58.0 % of GDP at the end of March 2016, most of which is owed by the private business sector. A particular concern relates to the foreign currency debt of private companies that receive most of their revenues in domestic currency: when the lira depreciates, their ability to service their foreign debt deteriorates.

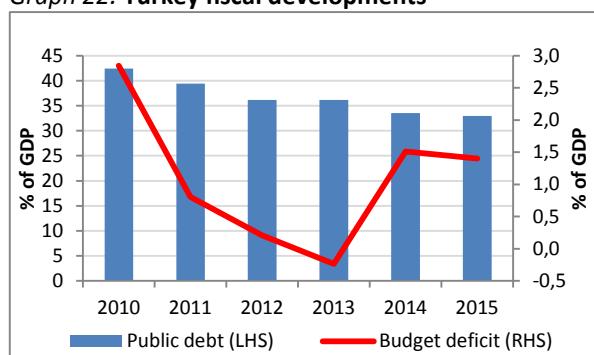
Inflation has remained in high single digits. This has significant costs in terms of macroeconomic stability, resource allocation and redistributive effects. In spite of the oil price decline, consumer price inflation increased from 8.2 % to 8.8 % year-on-year during 2015. Over the first nine months of 2016, inflation fell in the context of only modestly rising food prices and a relatively stable exchange rate. Headline inflation stood at 7.3 % in September which is still clearly above the official target of 5 %. The Turkish lira's bilateral exchange value against the euro increased marginally (1.0 %) between the end of September 2015 and the end of September 2016.

The central bank has eased monetary policy and continued to pursue multiple objectives as part of an overly complex monetary policy framework. Although price stability is the primary objective, the central bank is also pursuing macro-financial stability and trying to dampen exchange rate fluctuations. The central bank has kept the main policy rate (the one-week repo rate) unchanged at 7.5 % since February 2015, but has gradually lowered the overnight lending rate from 10.75 % to 8.25 % between March and September 2016. As a result, the average cost of funding has declined significantly in the reporting period. This easing of monetary policy is inconsistent with the inflation target. It has taken place against the background of repeated strong calls for lower interest rates from the President and parts of the government. Monetary policy should focus more on its primary objective of price stability in order to attain the official inflation target. Furthermore, a simplification of the monetary policy framework would improve its transparency and predictability and strengthen the central bank's credibility.

ERP policy guidance: Reinforce the central bank's focus on price stability in monetary policy by further tightening the policy stance against the backdrop of high (above-target) inflation rates and increasingly unanchored inflation expectations. A simplification of the monetary policy framework in line with the central bank's own forward guidance, published in August 2015, would help to buttress the credibility of the inflation targeting framework in place. Using the main policy rate, rather than a range of other instruments, in the conduct of monetary policy would be more transparent and strengthen the central bank's credibility in fighting inflation in the medium term.

On public finances, the budget deficit remained moderate and public debt continued on a sustainable path. The 2015 central government budget deficit is estimated at 1.2 % of GDP, which is marginally lower than in the preceding year (1.3 %) but slightly higher than originally planned (1.1 %). Revenues increased by 13.6 % year-on-year while expenditures rose by 12.8 %, both exceeding nominal GDP growth (11.7 %). General government debt increased by 9.8 % in absolute terms in 2015, but declined by 0.6 percentage points as a percentage of GDP to 32.9 %, i.e. it is clearly at a sustainable level. In a wider macroeconomic perspective, however, the fiscal policy stance has not appropriately addressed Turkey's persistent external imbalance in recent years. Public finances have an important role to play in raising overall domestic saving and reducing the need for capital inflows through an appropriately tight

Graph 22: Turkey fiscal developments



fiscal policy stance.

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

Overall, the Turkish economy remains vulnerable to bouts of financial uncertainty and changes in global risk sentiment and there is scope for adjusting monetary and fiscal policy to lower the macroeconomic imbalances. The persistence of a large current account deficit and the associated dependence on capital inflows makes Turkey prone to boom-bust cycles. The recent easing of monetary policy has been inconsistent with the official inflation target. Considering the continued overshooting of the inflation target and the chronically low private saving rate, monetary policy is too accommodative. Furthermore, fiscal policy should help to increase domestic saving by pursuing a sufficiently restrictive course.

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

Functioning of product markets

Business environment

Starting a business has become more cumbersome and remains expensive. It now required 8 separate procedures and took 7.5 days on average, up from 7 procedures and 6.5 days in 2014. The average cost of starting a business remained virtually unchanged in 2015 at 16.6 % of per capita income. On the positive side, obtaining a construction permit became significantly faster in 2015, but is still very burdensome. In 2015, the number of newly established businesses increased by 15.2 %.

Market exit also remained costly and has become even longer while insolvency proceedings were still heavy and inefficient. Closing a business has become significantly more time-consuming and has remained expensive. Insolvency procedures lasted an average of 4.5 years and recovery rates fell further to the very low level of 18.7 % on average. The number of businesses closing down or being liquidated fell by 13.4 % in 2015 compared with 2014.

The overall business environment continued to deteriorate due to targeted actions against critical media, business people and political opponents through the active use of the tax authority, the financial crimes unit and courts. In actions largely perceived to be politically motivated, the government has acquired active control of several media assets (Bugün, Kanaltürk, Zaman), companies (Koza-İpek group), private university preparation courses and universities (Haliç) by appointing trustees in their management. It also seized one bank (Bank Asya).

Following the failed coup attempt of 15 July and under the state of emergency rule, this type of state intervention has become more widespread. Several private companies, private foundations and universities were seized on the basis of alleged links with the Gülen movement. Allegations of wrongdoings by individual companies need to be subject to due process with respect for the separation of powers and the independence of the judiciary. Abstaining from politically motivated expropriation of private assets by court decisions, including independent media, would help restore investors' confidence.

ERP policy guidance: Strengthen the rule of law and the judiciary with a view to restoring investors' confidence.

A reasonably well-functioning legal system has been in place for several years in the area of property rights. Enforcement of commercial contracts was still a rather lengthy process, but the introduction of an electronic filing system for court users made enforcing contracts easier. Out-of-court dispute settlement systems have been operational already in banking, insurance and customs. Additional arbitration mechanisms have spread to other areas rapidly, particularly on employee-employer disputes. The number of cases referred to arbitration bureaus increased from 200 in 2014 to 1,160 in 2015 and reached 1,040 in the first quarter of 2016. The judicial system and its administrative capacity could be further improved.

State influence on product markets

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

There was no progress in improving the transparency of state aid. Legislation to implement the State Aid Law, originally scheduled to be passed into law by September 2011, has been postponed for yet another year until the end of 2016. The State Aid Authority has still not formally set up a comprehensive state aid inventory or adopted an action plan to align all state aid schemes, including the 2012 incentives package, with the *acquis*. (See also chapter 8.)

Privatisation and restructuring

Privatisation slowed down again. Following the surge in 2013, privatisation activity continued to decelerate in 2015, with the total volume of completed deals decreasing from EUR 4.8 billion (0.8 % of GDP) in 2014 to EUR 1.8 billion (0.3 % of GDP) in 2015. The share of the energy sector in privatisation tenders remained high. Competition could benefit from continued liberalisation in the markets for goods and services.

Functioning of the financial market

Financial stability

Despite declining profitability in banking, the financial sector generally performed well and continued to demonstrate resilience. The banking sector's loans-to-deposits ratio rose to 119 % in 2015, implying an increasing reliance on wholesale financing from abroad to sustain credit growth. The banking sector's profitability declined in 2015, both in relation to total assets and to total equity. The sector's capital adequacy ratio remained significantly above the regulatory target of 12 %, albeit declining from 16.3 % in 2014 to 15.6 % in 2015. The proportion of non-performing loans in total banking sector loans slightly increased, from 2.9 % in 2014 to 3.1 % in 2015.

Access to finance

Banks continued to dominate the financial sector. Their rapid credit expansion continued in 2015, with total bank lending increasing by 19.7 %. The value of banking sector assets as a ratio of GDP continued to increase, rising from 114 % in 2014 to 121 % in 2015. The size of the much smaller insurance sector (including private pensions) increased from 3 % of GDP to 3.1 %. State-owned

banks' share of total banking sector assets slightly increased to 31.3 % as of September 2015 (30.7 % in September 2014), while the share of foreign banks remained stable at 16.4 %.

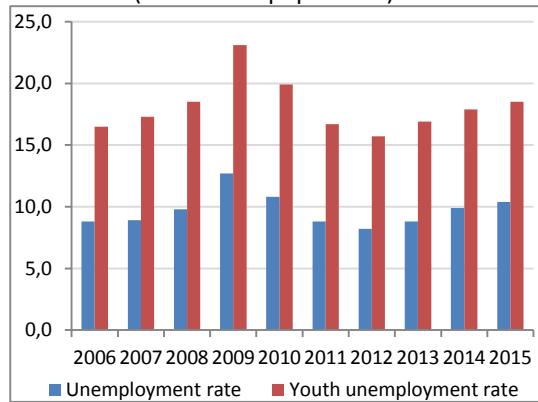
Functioning of the labour market

The number of jobs increased at a rate commensurate with output growth, but still below the growth rate of the labour force. In 2015, employment increased by 2.7 % which was less than the 3 % growth rate of the labour force. As a consequence, the unemployment rate increased by 0.5 percentage points to an annual average of 10.3 %. Labour force growth is mainly driven by a growing number of people of working age, but also by some rise in the labour force participation rate.

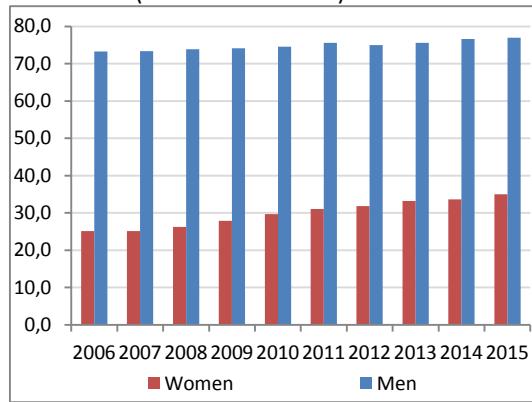
The employment rate of women has remained at a very low level. The overall employment rate increased to 53.9 % in 2015, with a large difference between men (75.3 %) and women (32.5 %). Despite the low proportion of women actively looking for work, their unemployment rate remains significantly higher than the unemployment rate for men. In addition, about one third of women who are considered to be employed are in fact unpaid family workers in the agricultural sector. Almost a third of young people are not in employment, education or training.

ERP policy guidance: Enhance further the control capacity of the labour inspectorate and enable tax authorities and the social security institution to ensure a correct declaration of wages in order to reduce informality.

**Graph 23: Unemployment in Turkey
(% of Active population)**



**Graph 24: Participation rates in Turkey
(% of Labour Force)**



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

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

Turkey has a **good level of preparation** in achieving the capacity to cope with the competitive pressure and market forces within the EU. Sufficient human capital exists and a relatively modern sectoral structure. Turkey is well-integrated with the EU market in terms of both trade and investment. **Some progress** was made in a number of areas, most notably through further liberalising the energy sector. Significant problems remained as regards the quality of education. There are also problems of access to education for girls. The lira's real appreciation has reduced the economy's price competitiveness.

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

- enhancing the comprehensive strategy in support of research and development;
- pursuing the education agenda and improving the qualifications of low-skilled workers.

Education and innovation

Although previous reforms and increased spending on education have generated a positive impact on educational attainment and enrolment rates, progress seems to have stalled recently. Significant problems remain over gender equality and the quality of education. Enrolment rates for pre-schooling (until the age of 6) increased to 55.48 % while they declined to 94.87 % for primary education and 94.39 % for lower secondary education. The reason for the decrease in primary education is that for children at the age of five, parents have a choice between pre-school or primary school. For upper secondary education, the enrolment rate is close to 80 %, while for higher education, it is close to 40 %.

Primary school results are lagging behind the EU average. According to the most recent PISA¹ study on the educational performance of 15-year-old students, Turkish students improved in all three subjects tested (science, mathematics and reading) between 2009 and 2012. However, the improvement was less pronounced than in the preceding three-year period and Turkey remained 48 points below the OECD average. The measures taken by the Government following the coup attempt of 15 July resulted in considerable staff dismissals and changes in education institutions, posing risks to the stability of Turkey's education sector. Regarding vocational education and training, the share of vocational and technical education in secondary education increased from 35.8 % in 2003 to 51 % in 2013. About 34 % of enterprises provide vocational and on-the-job training to their employees. However, a mismatch continues to exist between requirements of the labour market and skills produced by the educational system. Turkey needs to make better use of its human capital in order to stimulate sustainable and inclusive growth and competitiveness.

ERP policy guidance: Pursue the education agenda and improve the qualifications of low-skilled workers in order to make better use of human capital, in particular of young people.

R&D expenditure (both public and private) increased from 0.95 % of GDP in 2013 to 1.01 % of GDP in 2014, though remaining well below the government's current target of 1.8 % of GDP by 2018. About half of this investment came from the private sector. Turkey needs to develop a comprehensive strategy in support of research and development, while building closer cooperation between research institutions and economic operators.

ERP policy guidance: Enhance the comprehensive strategy in support of research and development; this should target an increase of total spending on research and development and build closer cooperation between research institutions and economic operators.

¹ OECD's Programme for International Student Assessment

Physical capital and quality of infrastructure

Improvements in the country's physical capital were modest. Total investment increased by 0.2 percentage points to 20.3 % of GDP in 2015, while the share of private investment remained stable at 15.9 % of GDP. Public investment increased slightly with a share of 4.4 % of GDP in 2015. Concentrating in financial services (banking and insurance), gross foreign direct investment (FDI) inflows as a percentage of GDP increased from 1.6 % in 2014 to 2.4 % in 2015.

Some progress was made in the energy sector, particularly in the electricity market. Market liberalisation and privatisation deals in generation and distribution activities encouraged new private investments, particularly in renewable energies. The Turkish electricity grid is formally synchronised and interconnected with the ENTSO-E Continental European system since January 2016, allowing market players to freely import and export electricity between the EU and Turkey and thus improving the security of supply. Turkish Energy Stock Company (EPIAS) has become fully operational, contributing to the development of a competitive and transparent energy platform. Further progress is needed to open the natural gas market, so that there is competition for the state-owned corporation BOTAS. A transparent and cost-based pricing mechanism for electricity and gas remains to be properly implemented.

The transport infrastructure was enhanced by lengthening the railway and road networks by 3.8 % and 0.4 % respectively in 2014. In telecommunications, the number of internet subscribers increased by 13.3 % and the internet penetration rate for households increased from 54 % in 2014 to 59.6 % in November 2015. No progress was made on aligning telecommunications legislation with the EU framework, but the regulator completed the tender over the operating rights for 4.5G licenses.

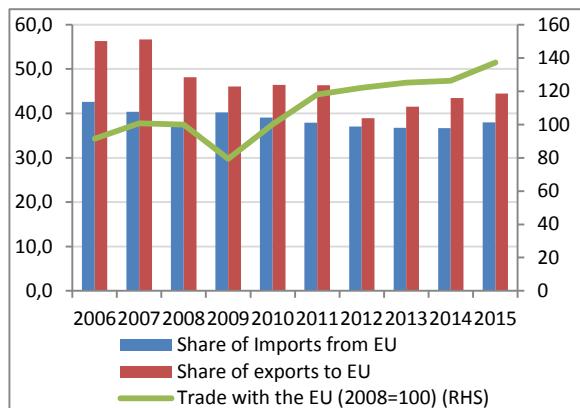
Sectoral and enterprise structures

In 2015, GDP grew by 4.0 %, while employment increased only by 2.7 %, indicating an increase in labour productivity in the overall economy. The sectoral breakdown of employment growth shows a continued shift towards the services sector, which accounted for 52.5 % of total employment (and 57.7 % of GDP) in 2015. Industry (including construction) accounted for 27.2 % of employment (and 24.1 % of GDP). Agriculture employed 20.6 % of the workforce and its share of GDP increased from 7.1 % in 2014 to 7.6 % in 2015, contrary to its long-term downward trend. The private sector's share of GDP continued to decline, falling by 0.4 percentage points to 84.3 % in 2015, but it is still quite large by EU standards. Small and Medium Sized Enterprises (SMEs) employ around three quarters of Turkey's work force and generate more than half of the economy's total value added. The capacity of financial institutions should be widened to provide also to SMEs the type of long-term funding options which are currently only available to large corporations.

Economic integration with the EU and price competitiveness

Turkey's trade and economic integration with the EU is high and increased further in 2015. The share of Turkish exports going to the EU increased from 43.5 % to 44.5 % while the share of Turkish imports coming from the EU increased from 36.7 % to 38.0 %. For the EU, Turkey has become the 5th largest trade partner, moving up one rank compared to 2014.

Turkey was the EU's 4th main export market and number 6 in terms of imports. The openness of the Turkish economy, measured by the value of exports and imports of goods and services as a percentage of GDP, decreased from 60.8 % in 2014 to 59.6 % in 2015.

Graph 25: Turkey trade integration with the EU

The EU remained the largest source of FDI flows into Turkey, although its share of total inflows decreased from 61.5 % to 57.6 % in 2015. Further trade integration with the EU would be stimulated by Turkey's elimination of impediments to the functioning of the EU-Turkey customs union (see *acquis chapter 1 - Free movement of goods*). Close to three quarters of the FDI stock in Turkey originates in the EU.

Turkey's international price competitiveness has deteriorated as a result of the 10.2 % appreciation of the lira in real effective terms between September 2015 and September 2016.

5.3. CONCLUSIONS

Regarding the **economic criteria**, the Turkish economy is well advanced and can be considered a functioning market economy. Still, the large external deficit makes the Turkish economy vulnerable to financial uncertainty, changes in global investors' sentiment and political risks. The central bank cut interest rates even though inflation remained well above the official target. The business environment continued to deteriorate due to targeted actions against critical media and business people and political opponents through the active use of the tax authority, the financial crimes unit and courts. The implementation of structural reforms to improve the functioning of the markets for goods, services and labour has stalled. Overall, there was backsliding.

Turkey has a good level of preparation in achieving the capacity to cope with the competitive pressure and market forces within the EU. Some progress was made in a number of areas, most notably through further liberalising the energy sector. Significant problems remain as regards the quality of education. There are also problems of access to education for girls. The lira's real appreciation has reduced the economy's price competitiveness.

6. BOSNIA AND HERZEGOVINA

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

The monitoring of these economic criteria should be seen in the context of the central importance of economic governance in the enlargement process. 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.

6.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Bosnia and Herzegovina is still at an **early stage** in developing a functioning market economy. **Some progress** has been made, such as steps to modernise labour legislation, improve the business environment and address weaknesses in the financial sector. However, achieving stronger and sustainable economic growth will require a more efficient public sector and a more dynamic private sector development. Strong and continued political support for the swift implementation of much-needed structural reforms, in line with the agreed Reform Agenda, will be key.

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

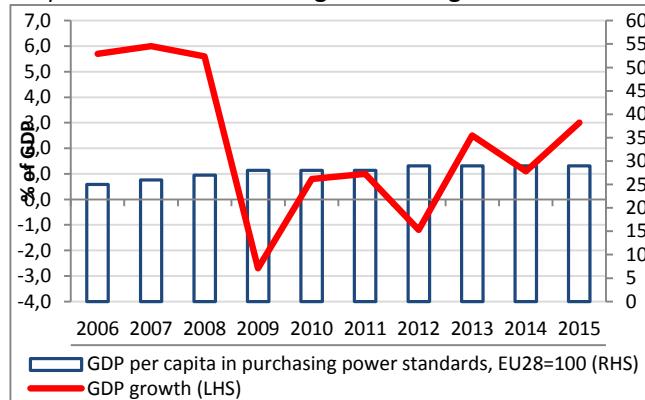
- improving the quality of public finance by enhancing the growth-friendliness of investment, improving the targeting of social spending, and strengthening debt management;
- strengthening the financial sector, by addressing non-performing loans and enhancing banking sector supervision and developing a new resolution framework;
- improving the provision and quality of timely and exhaustive statistics, increasingly applying European and international standards.

Economic governance

Bosnia and Herzegovina has strengthened its commitment to market-oriented reforms. Implementation of the Reform Agenda and other reforms in view of complying with the economic accession criteria has made progress. In addition, the authorities agreed with the IMF on a 3-year reform programme in support to the Reform Agenda, and which is in force since September. However, chronic and time consuming disputes between the various governmental stakeholders resulted in substantial delays and have strongly impeded the effectiveness of economic policy. In the 2016 Economic Reform Programme (ERP), the authorities presented, among others, an ambitious, back-loaded fiscal consolidation path, substantially lowering both revenue and expenditure. However, a particular concern is the disproportionate use of delaying investment in order to achieve spending reductions. Important ERP policy guidance measures agreed at the Economic and Financial Dialogue on 12 May 2015 have not been implemented.

Macroeconomic stability

Graph 26: Bosnia and Herzegovina GDP growth



Economic growth remained resilient, but growth is still too low to lead to a noticeable improvement in the citizens' living conditions. In 2012, the economy contracted by 1.2% and, as a result of heavy flood damages, output growth reached only 1.1 % in 2014. This brought average annual GDP growth over this period to 1.4 % only. However, in 2015, output growth bounced back to about 3 %. In the first half of 2016, output growth was 1.7 %. Important drivers of growth were domestic demand, in particular private consumption, as

well as external demand. The resilience of private consumption is probably a result of stable inflows of workers remittances, and improving real disposable income, benefitting from low inflation and increasing employment. Domestic and foreign investment appears to have remained subdued, reflecting a poor business environment but also concerns on longer-term growth perspectives. Industrial production strengthened in the second half of 2015 and first half of 2016, partly reflecting stronger demand from abroad. Overall, data since the beginning of the year point to moderate but solid economic growth. Still, *per capita* GDP¹ remained at about 29 % of the EU average in 2015, only slightly up from 28 % in 2011.

External imbalances have continued to decline, but remain substantial. In 2015, stronger export demand and lower prices for the import of energy and raw materials have resulted in a slight improvement in the country's trade and current account balances. The trade deficit shrank from 29.6 % in 2014 to 26.4 % in 2015, while the current account deficit dropped from 7.4 % of GDP in 2014 to 5.7 % in 2015. The substantial trade deficits are still primarily financed by inflows of transfers, such as remittances, and by service exports. Net foreign direct investment (FDI) declined from 2.8 % of GDP in 2014 to around 1.5 % of GDP in 2015, which is low when compared to peer countries. Net foreign exchange reserves continued to increase, reaching a robust level of about 30 % of GDP in mid-2016, covering some six months' worth of imports.

Table 6.1:
Bosnia and Herzegovina - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	1.0	-1.2	2.5	1.1	3.0	1.7
Private consumption	Ann. % ch	1.6	2.2	2.6	3.0	n.a	n.a
Gross fixed capital formation	Ann. % ch	6.8	6.3	-2.4	9.5	n.a	n.a
Unemployment rate	%	27.6	28.2	27.6	27.6	27.9	n.a.
Employment	Ann. % ch	-1.6	-0.4	0.6	2.7	1.1	2.0
Wages	Ann. % ch	4.4	1.5	0.1	-0.1	0.0	0.6
Current account balance**	% of GDP	-9.5	-8.7	-5.3	-7.4	-5.7	-6.0
Direct investment (FDI, net)**	% of GDP	2.6	1.9	1.3	2.8	1.5	1.5
CPI, average	Ann. % ch	3.7	2.0	-0.1	-0.9	-1.0	-1.5
Exchange rate BAM/EUR	Value	1.96	1.96	1.96	1.96	1.96	1.96
General government balance	% of GDP	-1.2	-2.0	-2.2	-2.0	0.7	2.0
General government debt	% of GDP	32.8	36.6	37.7	41.6	41.9	n.a

** refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat

¹ Expressed in purchasing power standards.

Monetary policy has remained in line with the country's policy challenges. The currency board arrangement with the euro as anchor currency was maintained and continues to enjoy a high level of confidence and credibility. This approach has served the economy well so far. However, it also implies that the burden of adjustment to external shocks has to be accommodated by other policy areas, including fiscal policy. This requires a more responsible fiscal policy, necessitating the building-up of sufficient fiscal buffers and a stronger emphasis on medium-term stability.

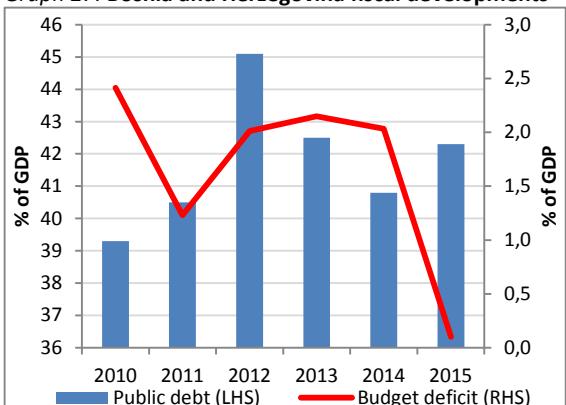
The overall price level continued to decline, although at a slower pace. In the first eight months of 2016, the overall level of consumer prices was 1.3 % lower than a year before. The drop in the price level was mainly driven by a limited number of commodity groups, such as transport, while prices for housing, health and education rose by some 1-2 %. Important factors for the low domestic inflation were lower prices for imported commodities, such as energy and basic commodities and the stable exchange rate towards the Euro.

ERP policy guidance: Develop a comprehensive strategy to foster the resolution of non-performing loans by banks, including all relevant stakeholders with a view to reducing risks to financial stability and the real economy. Follow-up on plans to upgrade the legal infrastructure of the financial system and conduct an asset quality review of smaller banking entities. Establish a bank lending and inflation expectations survey in order to better gauge underlying credit and price dynamics.

The general government accounts were close to balance in 2015, although the quality of fiscal governance remained low. Preliminary data point to a slight surplus in the overall public sector accounts of some 0.7 % of GDP in 2015, compared to a deficit of 2.0 % the year before. This substantial fiscal adjustment of 2.7 percentage points of GDP appears to have been primarily the result of delayed investment spending and a maintaining spending on public sector wages at pre-year level. As a result, public spending dropped from 45.8 % of GDP in 2014 to 43.2 % in 2015. 2 percentage points of this drop in spending came for lower investment, declining as a percentage of GDP from 4.1 % in 2014 to 2.0 % in 2015. An important factor for the sharp decline in spending has been the difficulty in accessing international capital markets. Total revenues of the public sector declined slightly, from 43.8 % of GDP in 2014 to at 43.2 % in 2015.

However, both, the spending and the revenue ratios are still rather high when compared to peer countries. Despite ongoing preparations to improve the targeting of social spending and to reduce payment arrears, the quality of public spending is still very low.

Graph 27: Bosnia and Herzegovina fiscal developments



The increase in public debt slowed down in the first half of 2016. General government debt has steadily increased in recent years, reaching 41.9 % of GDP by the end of 2015. However, during the first half of 2016, the increase in debt decelerated, partly reflecting difficulties in accessing foreign capital markets. Debt service payments in 2015 increased to 0.8 % of GDP on the back of intensified issuing of short-term government securities to make up for the non-disbursement of tranches under the IMF Stand-by Arrangement.

The macroeconomic policy mix is largely appropriate. The approach of maintaining an euro-based currency board arrangement and low fiscal deficits has supported confidence and avoided the build-up of major macroeconomic imbalances. However, the implementation of fiscal policy has not devoted sufficient attention to improving the quality of public spending, for example through a better targeting of social transfers and stronger public investment, which would increase the country's growth potential in the medium-term.

ERP policy guidance: Improve the quality of public finances: Enhance the growth-friendliness of public spending, among others by increasing public investment, and contain spending for public employment. Improve the targeting of social spending and establish a comprehensive inventory of public sector payment arrears. Furthermore, strengthen the country-wide public debt management capacities, in particular improving cooperation and the flow of information from local data providers to the state level. Set-up an enforceable rules-based framework to instil discipline at all levels of government.

Functioning of product markets

Business environment

The legal framework concerning market entry and exit has improved, although actual barriers to entering and leaving product markets are still high. The Federation entity adopted a new company law and both entities have started to improve their bankruptcy legislation, in particular with a view to simplify and accelerate procedures.

However, there is still much to be done to align with international standards. Registration costs have been marginally reduced. However, overall, the number and duration of required procedures for entering or leaving the product market are still high and constitute a competitive disadvantage for the country.

ERP policy guidance: Improve the provision of timely and exhaustive statistics, applying European and international standards, in particular in the area of population statistics, national accounts and government finance statistics. Furthermore, strengthen the provision of data from data providers to producers of official statistics.

The rule of law and the functioning of the judiciary are still crucial issues. Property rights are not yet fully established, as in some areas the coverage of real estate registration is still low. Regulatory and supervisory institutions often lack necessary resources and independence. In particular, financial sector supervision suffers from fragmentation and a lack of competences and resources. The country's international ranking in terms of business environment is very low.

The informal economy is estimated at 30-50 % of GDP and plays a central role, providing (unregistered) jobs and income but also distorting competition and eroding the base for taxation and social security contributions. As a result, rates for taxes and social security contributions are higher than would be necessary otherwise. This leads to a significant tax wedge on labour, which in turn impedes the creation of formal employment and has a negative impact on the country's international competitiveness.

ERP policy guidance: Introduce e-payment services on taxation and fully implement the law on electronic signature in order to increase transparency and reduce space for tax evasion, corruption and regulatory complexity.

Strengthening the rule of law, simplifying contract enforcement procedures and fighting corruption remain essential. Although a few steps have been taken to improve the legal rules governing business, the situation remains problematic. The country's administrative and judiciary capacities are limited, especially on settling commercial disputes, which often are still not discussed in commercial, but civil courts. The enforcement of commercial contracts remains cumbersome: When measuring the number of procedures, the necessary time and the involved costs, no significant improvement appears to have taken place during the last 10 years, requiring 37 different procedures, taking on average 595 days and costing 34 % of the claim value.

State influence on the product market

Direct state influence on the economy has remained significant, with public sector spending accounting for more than 40 % of GDP, generating about 22 % of the country's value added and employing about 26 % of the country's labour force. In the Federation entity, the role of state appears to be significantly higher than in Republika Srpska, reflecting the more complex administrative structures but also the fact that privatisation of state-owned companies is still at an early stage.

State subsidies and guarantees are still significant and constitute a heavy burden on public finances. According to available data, public sector subsidies to industry and agriculture account for some 1.3 % of GDP. Together with loan guarantees provided by the Entities to non-viable public enterprises this represents a significant cost and in particular a substantial contingent liability, impeding the predictability of public spending.

Privatisation and restructuring

The privatisation process in the Federation entity started in 1999 but continued to suffer from delays despite the adoption of privatisation strategies in 2014 and 2015. Attempts to sell 14 earmarked companies were largely unsuccessful, so far. This leaves the assets still to be privatised at two-thirds of the initial stock of state-owned capital for privatisation. The Federation entity has made some progress in preparing privatisation projects. In the *Republika Srpska* entity the privatisation of state-owned companies is more advanced. However, progress in selling or liquidating remaining assets has been limited. Overall, strategic sectors such as transport, energy (and telecom in the Federation entity) are still dominated by state-owned companies. Proceeding with privatisation would stimulate competition in those sectors and relieve public finances from a recurring burden.

Functioning of financial markets

Financial stability

Banking sector supervision and resolution suffer from fragmentation and insufficient data sharing among relevant stakeholders. The central bank's analytical capacities are still not sufficient. The sector's overall capital endowment with respect to its risk, the so-called capital adequacy ratio, recovered to 15.8 % by mid-2016. On country level this is above the regulatory minimum of 12 %. However, in some cases, weak capital endowment and insufficient surveillance are an issue. Banking sector profitability has been low, but improved in mid-2016. Credit risk indicators for the banking system have been improving slightly: Ratios of non-performing loans (NPLs) were close to 12 % in mid-2016, which is lower than in many peer countries but still high in terms of credit risks. Interest rate spreads have remained at a rather high level, at some 4.5 percentage points for corporate loans and at above 6 percentage points for household loans. Although spreads for household loans have declined during the last months, such high differences point to weaknesses in the sector's efficiency. Legislative changes to facilitate loan restructuring and NPL solutions are still insufficient.

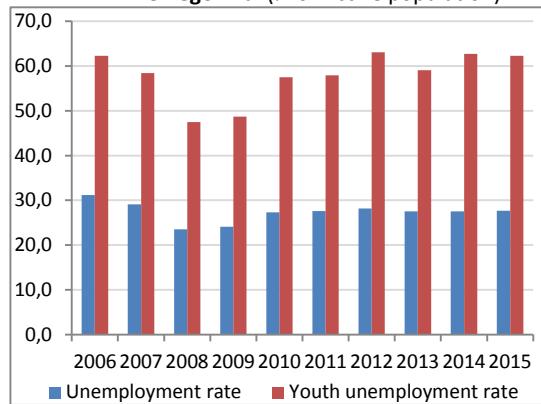
Access to finance

Bank lending to the private sector has remained low, in particular loan provisioning to corporations. The share of bank lending to GDP is low, accounting for 59 % by end-2015. Furthermore, credit lending has been growing at a low rate, largely due to weak lending to private corporations. The financial system continues to be dominated by the banking sector, which accounted for 87 % of total financial assets. The number of banks is high in relation to the available market size, although it has declined to 25 after the licences of two small local banks have been withdrawn and two smaller banks have merged. The sector is dominated by a few larger banks, while the size of the remaining banks is rather small. The share of foreign-owned assets in the banking sector increased to over 90 %, which is high but in line with peer countries. Only two majority state-owned banks remain,

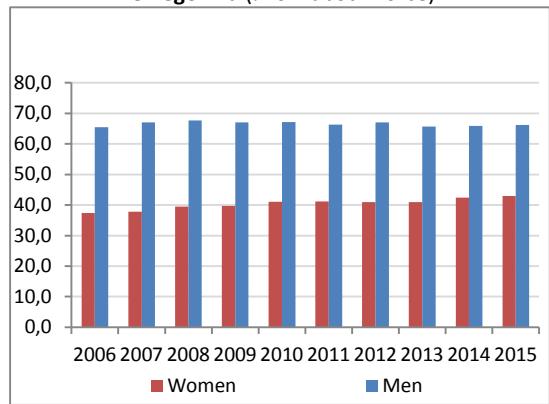
of which one is a development bank, which is in the process of liquidation. Both together account for less than 3 % of the sector's assets. The size of capital markets in relation to GDP is limited, with a value of capital market assets accounting for about 33 % of GDP. The size of the non-banking sector, mainly investment funds and insurance companies, increased slightly, with the sector's assets reaching 13 % of GDP by end-2015. However, this is still markedly below pre-crisis levels.

Functioning of the labour market

Graph 28: Unemployment in Bosnia and Herzegovina (% of Active population)



Graph 29: Participation rates in Bosnia and Herzegovina (% of Labour Force)



Substantial and persistent labour market imbalances point to a poor functioning of the labour market's allocation mechanism, alongside issues related to education and training. Unemployment rates have declined in recent months. However, the level of unemployment is still high. In terms of registered unemployment, the rate decreased from 43.6 % in 2014 to 42.9 % in 2015, while results from the annual labour force survey (using ILO methodology, which accounts for undeclared work) point to a decline in unemployment, from 27.7 % in April 2015 to 25.4 % in April 2016. This decline in the rate is mainly a result of increased employment, while the number of unemployed has remained unchanged. The significant and persistent difference between the registered and survey-based labour figures indicates a fairly large informal labour market. At the same time, activity and employment rates remained at strikingly low levels of 44.1 % and 31.9 % respectively. Employment in the public sector continued to account for a large proportion of employment (31.2 % in 2015). The high proportion of long-term unemployment, accounting for some 85 % of job-seekers reflects a high structural component in unemployment. The high youth unemployment figure dropped slightly, from 62.7 % in 2014 to 62.3 % in 2015. Furthermore, persistent and large differences between female and male participation rates (32.1 % and 54.9 % in 2016) suggest that labour market conditions remain adverse for women.

ERP policy guidance: Reinforce the capacities of the employment services and target active labour market policies in particular to vulnerable youth, women and long-term unemployed. Reduce the unsupportive tax wedge and disincentives for the unemployed and inactive persons to take up formal work. Improve the co-operation between the education system and labour market institutions.

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

Being competitive in the EU also requires the existence of a functioning market economy.

Bosnia and Herzegovina is **at an early stage** in achieving the capacity to cope with competitive pressures and market forces within the Union. For the time being, the limited progress in proceeding with the reform agenda measures has not yet translated into noticeable improvements in the country's competitiveness. The overall level of education and spending on research and development are low. The quality of the country's physical capital is eroded and transport and energy infrastructure are insufficiently developed. The speed of structural adjustment and further trade integration are slow.

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

- improving the efficiency of public investment, in particular with respect to infrastructure investment;
- increasing the country's attractiveness for foreign and domestic investment by, for example, accelerating improvements in the business environment and price competitiveness;
- improving the quality of education and training.

Education and innovation

The overall level of education is low, as is spending on education and research and development. Investment in research and development has remained at low levels in recent years at a marginal 0.3 % of GDP, resulting – among others - in a low percentage of research and development personnel in the workforce (of 0.1 %). This is below the regional average. Public sector spending on education is relatively high at some 5 % of GDP, but the resulting output is one of the weakest in the region. This is probably directly linked to the complex and highly fragmented education system, with competences split at entity level, and in the case of the Federation entity even at cantonal level. This fragmentation together with a lack of coordination impedes the efficient and coordinated use of scarce public funds and results in a lack of common standards for various levels of education, as well as in teacher training and performance evaluation. Participation in pre-school education increased slightly compared to 2014 but the enrolment rate still remains very low at 15 %. Enrolment rates for tertiary education are also low at around 47 %, and are - despite an upward trend - far below the regional average. Completion rates in higher education are also low, averaging at 45 %, implying a high degree of internal inefficiency. The country's illiteracy rate of 2.8 % is one of the highest in the region. A wide skills mismatch is an important impediment for graduates to enter the labour market. As pointed out in a recent EU funded study, both employers and graduates believe that the education institutions do not equip students with key soft skills, such as problem solving, organisational, decision-making, foreign languages, etc., which are important for employability. The educational provision in vocational education and training (VET) does not function well as most VET graduates do not find employment and subsequently enter higher education.

Physical capital and quality of infrastructure

The quality of the country's physical capital endowment has remained low. Private investment, in particular foreign direct investment, and public investment have remained below their long-term averages, with a 5-year average of 17.5 % of GDP, compared to an average of 20 % during a longer term. In particular, public investment was less than 4 % in 2015. Net FDI inflows dropped from 2.6 % in 2014 to 1.4 % in 2015. In view of the need to accelerate the country's catching-up process, this low investment performance is clearly insufficient and a serious reason of concern. Despite political commitments from the authorities to raise investment, public investment usually is a victim of

budgetary constraints while private investment is impeded by slow progress in improving the business environment.

Transport and energy infrastructures are insufficiently developed. The lack of coordination and cooperation between government levels to set up properly-functioning energy and transport markets and a single or harmonised legal and regulatory framework blocks the required significant upgrades and the considerable growth opportunities in these sectors. At the same time, the markets for electricity and gas remain fragmented and dominated by key incumbent companies.

ERP policy guidance: Set up a common economic space and systematic coordination mechanisms between all government levels. Adopt a country-wide transport strategy and a country-wide energy sector reform strategy in compliance with the country's obligations under the Energy Community Treaty.

The digitalisation of the economy is relatively low. The overall fixed broadband penetration rate increased to 17 %. The telecommunications sector policy has not been adopted by the Council of Ministers, blocking potential new entrants' market access. Bosnia and Herzegovina remains the only country in the region without a broadband strategy.

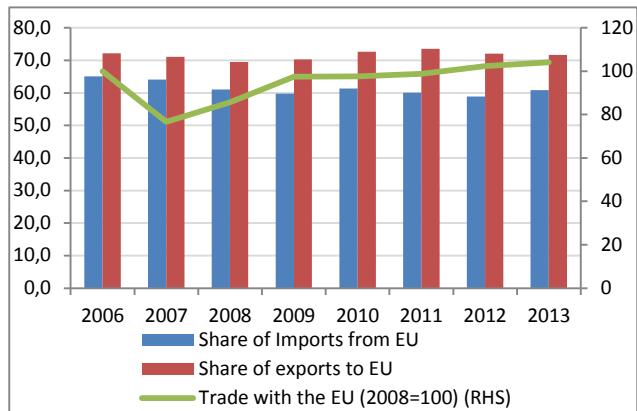
Sectoral and enterprise structures

The structure of the economy has remained largely unchanged. The agricultural sector accounts for a relatively high 7 % of GDP and 17 % of employment, reflecting the many small, fragmented and inefficient farm plots. Industry (incl. construction) provides a relatively high 26 % of GDP and 30 % of employment. The service sector is the largest sector in terms of employment and value generation. However, this reflects to a large extent the dominant size of the public sector and the important role of the trading sector. There seems to have been remarkably little change in the sectoral structure of the economy. However, lack of information on the informal sector might mask important changes.

Small enterprises are a crucial part of the economy. The latest Statistical Business Register indicates that the majority of enterprises, namely 75 % of all enterprises are micro-enterprises with less than 10 employees, while small enterprises, with 10-49 employees, represent 18 % of all companies. Large companies with more than 250 employees account for only 1 % of enterprises. Micro- and small enterprises are mainly active in trade and to a smaller extent in manufacturing. Overall, companies with less than 50 employees account for 93 % of all companies. Access of small, micro and start-up enterprises to bank lending is difficult, partly due to inefficient credit guarantee schemes. SME support schemes are in place but their implementation is very cumbersome.

Economic integration with the EU and price competitiveness

Graph 30: Bosnia and Herzegovina trade integration with the EU



Trade integration with the EU is high, with more than 70 % of exports directed towards the EU-28. During the first 8 months of 2016, 72.2 % of total exports were sent to the EU-28. However, the regional trade structure is very concentrated, as more than half of total exports were directed to only 3 countries, to Germany, Italy and Croatia. Compared to the same period a year before, the EU share dropped slightly, mainly due to strong export growth to non-EU countries, such as Turkey. The main export products are processed commodities and raw materials. Overall, the country's

openness to trade is relatively low when taking into account its economic size, with exports and imports accounting for some 90 % of GDP. Furthermore, the range of export commodities is not very sophisticated. These two factors point to a limited competitiveness of the economy.

The EU is a major investor in Bosnia and Herzegovina, accounting for 65 % of total FDI stocks, with Austria and Slovenia accounting for the largest shares. Non-tariff barriers to trade with the EU, such as required sanitary standards, remain a significant problem and demand structural and regulatory reforms.

Price competitiveness deteriorated in terms of unit labour costs. The country's currency board regime, with the Euro as its anchor, also resulted in a deterioration of Bosnia and Herzegovina's nominal price competitiveness, as the Bosnian currency appreciated against many currencies of important trading partners, such as the US, Turkey and Russia. However, due to the persistently low inflation, the real effective exchange rate depreciated slightly, counteracting to some extent the negative development on the country's price competitiveness.

6.3. CONCLUSIONS

As regards the **economic criteria**, Bosnia and Herzegovina is still at an early stage in developing a functioning market economy. Some progress has been made in modernising the labour legislation, improving the business environment and addressing weaknesses in the financial sector in the framework of the agreed Reform Agenda. However, the public sector is inefficient and private sector development is slow. Strong and continuing political support for the swift implementation of much-needed structural reforms, in line with the agreed Reform Agenda, will be key.

Bosnia and Herzegovina is at an early stage in building the capacity to cope with competitive pressure and market forces within the Union. There was no progress in improving the country's competitiveness, but implementation of Reform Agenda measures is ongoing.

7. KOSOVO*

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

The monitoring of these economic criteria should also be seen in the context of the central importance of economic governance in the enlargement process. 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.

7.1. THE EXISTENCE OF A FUNCTIONING MARKET ECONOMY

Kosovo is at an **early stage** in developing a functioning market economy. **Some progress** was made, particularly on supporting export-oriented businesses, improving contract enforcement, especially within the financial sector, and access to finance. The pursuit of economic reforms is ongoing, but decisions related to war-veterans' benefits can challenge fiscal sustainability and affect Kosovo's relations with international financial institutions. The persistent trade deficit reflects a weak production base and poor international competitiveness. Reliance on remittances and the widespread informal economy additionally decrease employment incentives resulting in low labour force participation, especially among women, and high unemployment rates in particular among young and unskilled workers.

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

- ensuring fiscal sustainability, especially by establishing an independent fiscal body and strengthening independent forecasting;
- improving the efficiency of capital spending, particularly through improvements in project preparation and management capacities at central and local government levels;
- improving bankruptcy and insolvency procedures.

Economic governance

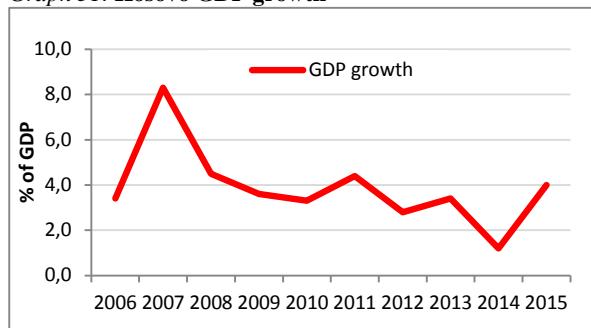
The government's strategic documents show a strengthened commitment to pursuing economic reforms. However, Kosovo's economic policy is characterised by ad hoc decision making and slow policy implementation. The Economic Reform Programme (ERP) and the National Development Strategy both reflect a commitment to pursue a stable fiscal policy and structural reforms. However, the ERP policy guidance from 12 May 2015 has only been partially implemented. The second International Monetary Fund (IMF) disbursement has been delayed due to the underestimated costs stemming from the introduction of new benefits for war veterans, which represent a significant risk for Kosovo's fiscal stability. The Stabilisation and Association Agreement between Kosovo and the European Union entered into force and establishes a permanent free trade arrangement with the EU. If complemented by specific reforms, it will facilitate economic development in Kosovo.

ERP policy guidance: To improve forecast accuracy enhance technical capacities of the services preparing the macro fiscal framework, ...

Macroeconomic stability

Kosovo's economy is showing signs of recovery, albeit insufficient to close the development gap with the countries in the region and to increase the level of employment. Preliminary data show that economic growth picked up to 4 % of GDP in 2015 which is above the average annual growth of 3 % over the last five years. Consumption and investment are the largest contributors to growth, while exports remained weak. Stronger private consumption was fuelled by higher remittances, higher consumer lending, and increased pensions and wages in the public sector. The recovery of investments was supported by the on-going construction of the highway to Skopje and doubled foreign direct investment (FDI) inflows. Kosovo's growth model still mainly relies on consumption and investments in infrastructure as other production capacities are underdeveloped. Growth remained strong in the first quarter of 2016, at around 3.8 %.

Graph 31: Kosovo GDP growth



External imbalances worsened in 2015, despite a slight improvement in the trade deficit. The current account deficit increased to 9.1 % of GDP in 2015, the highest since 2011. A fast growing inflow of remittances (13 % of GDP in 2015) and a slightly decreasing trade deficit (30.4 % of GDP in 2015) were not enough to offset the large outflow of FDI-related profits and a continuation in the decline of transfers to the government. However, FDI inflows more than doubled, amounting to 5.6 % of GDP, after recording a historic low of 2.7 % in 2014. Almost 60 % of all FDI went into real estate and only 7.1 % to the manufacturing sector. The real estate, financial intermediation and construction sectors attract most FDI, reflecting a weak business environment and few 'greenfield' investment opportunities. Kosovo's gross external debt remained relatively low at 33.4 %¹ of GDP, and is not a cause for immediate concern.

Table 7.1:
Kosovo - Main economic trends

		2011	2012	2013	2014	2015	2016 H1
Gross domestic product	Ann. % ch	4.4	2.8	3.4	1.2	4.1	3.5
Private consumption	Ann. % ch	3.5	2.9	2.0	4.9	3.8	5.9
Investment	Ann. % ch	7.9	-12.9	-0.3	-5.0	11.3	14.6
Unemployment rate	%	44.8	30.9	30.0	35.3	32.9	27
Employment	Ann. % ch	n.a	n.a	11.7	-4.4	-8.2	6.0
Wages	Ann. % ch	n.a	n.a	n.a	n.a	n.a	n.a
Current account balance*	% of GDP	-13.7	-7.5	-6.4	-7.8	-9.1	-10.9
Direct investment (FDI, net)*	% of GDP	7.9	4.2	4.7	2.2	5.0	3.8
CPI, average	Ann. % ch	7.3	2.5	1.8	0.4	-0.5	-0.1
Exchange rate EUR/EUR	Value	1.00	1.00	1.00	1.00	1.00	1.00
General government balance	% of GDP	-1.7	-2.6	-3.1	-2.2	-2.0	n.a
General government debt	% of GDP	5.3	8.1	8.9	10.6	13.1	13.8

* refers to a 4 quarters moving average.

Sources: Data Insight, Eurostat, Local authorities

As a small open economy, price developments are dependent on import prices, specifically food and energy prices. The consumer price inflation in Kosovo has been on a downward trend since 2011, resulting in deflation of 0.5 % in 2015. Inflation stabilised in the first half of 2016 at around 0 %, despite a slow pick up in core inflation. Import prices decreased 1.2 % in 2015 and further by 4.2 % in the first half of 2016.

¹ Central Bank of Kosovo data

The fiscal situation improved in 2015 but ad-hoc decision making still affects public finances negatively. Budget revenues rose 8.9 % in 2015 driven by strong growth in tax revenues. Both VAT and corporate income tax increased due to higher turnover and profitability of Kosovo's 10 largest companies.

Expenditure freezes and cuts were complemented with the VAT rate increase to 18 % and the introduction of a new lower rate of 8 % for some essential goods. Furthermore VAT exceptions for imported capital goods were introduced to stimulate domestic production.

The overall budget deficit amounted to 2 % of GDP (or 1.5 % of GDP when adjusted by the provisions in the fiscal rule, well below the 2 % limit). Capital expenditure was utilised at 95 % of the planned amount, but mainly due to the advanced payments for construction of the Route 6 highway.

The execution of the 2016 budget is characterised by higher than expected revenue, but it could be jeopardised by a substantial increase concerning the expenditure on war veterans' benefits.

Stronger economic growth, the effect of a full year VAT and excise changes, and improved collection of tax arrears substantially increased budget revenue. While most of the expenditure items stayed in line with the budget expectations, reflecting increases due to the implementation of the collective agreement for public sector employees, increase in social assistance, implementation of the law on state-financed pension schemes, and maintenance of higher subsidies for agriculture, the expected significant increase of war-related benefits is a cause for serious concern. This increase also reflects poor budget planning and a lack of budget impact assessment. The 2016 budget aims at a fiscal deficit of 1.6 % of GDP, well within the fiscal rule limit.

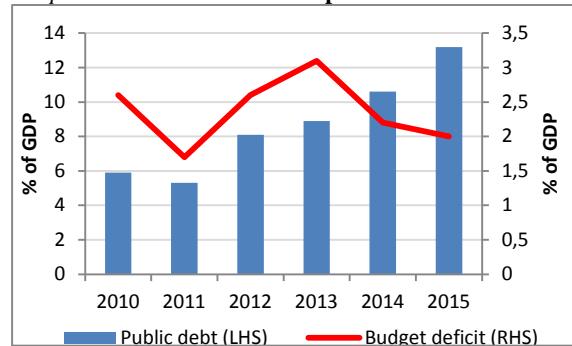
Kosovo has a relatively low level of public debt. Total public debt continued to increase, reaching 13.1 %¹ in 2015, with an increasing share of domestically issued treasury bills. Prudent fiscal policy is crucial given Kosovo's reliance on short-term domestic financing and loans from international financing institutions, and its inability to issue international debt in the absence of a credit rating.

Fiscal rule enforcement and monitoring mechanisms need to be strengthened. Ad hoc fiscal decision-making is the main risk to public finance. Budget planning procedures have not been transparent, and budget spending programmes are not joined up with identified policy priorities. The newly adopted wage rule aligning salary increases in the public sector from 2018 with the nominal GDP growth rate will provide some stability to the current expenditure. A new exemption to the fiscal rule was adopted increasing fiscal space for capital investment projects financed by international institutions.

ERP policy guidance: ..., strengthen parliamentary oversight capacities in evaluating budget planning and execution as well as fiscal risks and take first steps towards establishing an independent fiscal body.

ERP policy guidance: Identify offsetting measures for recent increases in categorical benefits while preserving the share of capital spending and address persistent under spending of the capital budget by improving project preparation and management capacities at central and local administration levels.

Graph 32: Kosovo fiscal developments



¹ Public debt figure does not include Kosovo's share of the Paris and London Clubs debt of the former Yugoslavia.

Due to Kosovo's unilateral adoption of the euro, the available policy mix comprises only fiscal policy and structural reforms. Kosovo's economy has been continuously growing since 2003, but it is difficult to establish any causal relation between growth and fiscal policy. Fiscal policy has been dominated by non-transparent, ad-hoc decision-making, with little long term planning. This has resulted in continuous increases in current spending. Nevertheless, budget deficit and public debt remain low. Implementation of structural reforms is currently at an early stage.

Functioning of product markets

Business environment

Some progress was made in simplifying business registration and insolvency procedures. The establishment of 29 one-stop shops has reduced the time needed to register a company to 3 days. The announced online registration has, however, still not been fully implemented. The main obstacles include a weak and unaccountable administration, underdeveloped infrastructure (especially an unreliable electricity supply), weak rule of law, corruption; a widespread informal economy and poor education outcomes. There was an increase of 4.6 % in the number of newly established enterprises mainly in the agricultural sector. A newly adopted law on bankruptcy is expected to improve market exit and speed up payments to creditors.

Despite some progress made on the legal rules governing businesses, they are still insufficiently implemented. The very weak institutional capacity to enforce the law, combined with widespread corruption, continues to negatively affect the business environment. The judicial system suffers from poor accessibility, inefficiency and delays. Little progress was recorded in terms of clearing court backlogs of unresolved cases (400 000 in July 2015). The adopted changes to the law on enforcement procedures should contribute to the efficiency of commercial cases and improve contract enforcement and collections. Further work is needed on reviewing the civil code on business lawsuits and practices and on developing property (cadastre) databases. The Office of the Auditor General's annual report identifies numerous legal violations in ministries, municipalities and other public institutions but those responsible are rarely prosecuted.

ERP policy guidance: Implement the action plan of the strategy for the fight against the informal economy. In particular, speed up the risk assessments focusing on the sectors and branches most vulnerable to informalities in order to identify and apply appropriate corrective measures.

State influence on product markets

There was no progress on developing institutional capacity to control state aid and subsidies are still being provided without a proper strategy and evaluation. Among centrally-managed enterprises, only two, the Kosovo Energy Corporation and Post and Telecommunications Kosovo, continued to generate a profit in 2015. Appointment procedures of publicly-owned enterprises management are often subject to political influence. Merit-based management selection procedures and anti-corruption mechanisms need to be strengthened. The government continued providing EUR 46 million worth of subsidies and investment grants to the agricultural sector but the link to productivity gains remains weak. Tax and customs exemptions continued for certain sectors (raw materials, IT). However these had a limited impact on investments and exports in 2015. The assembly adopted a law on strategic investment with the aim of facilitating decision making regarding private sector projects deemed strategic by the government. Financial support to the economic zones and industrial parks continued, but without a clear plan or a transparent impact and gap analysis. Government influence on price controls for utilities and postal and telecommunications services continued.

Privatisation and restructuring

Overall, very limited progress was achieved in the privatisation and liquidation of socially-owned enterprises and in the restructuring of publicly-owned enterprises. Although the board of

the Privatisation Agency was appointed in December 2015, the privatisation agenda was put on hold and no new privatisations took place. With the appointment of a new management board some progress has been made in the functionalisation of the Agency, but undue interference adversely affects institutional credibility and efficiency. The unresolved status of property rights and lengthy legal proceedings in dealing with financial claims on privatised assets hinder the privatisation process and delay disbursement of privatisation revenue held at the central bank.

Functioning of the financial market

Financial stability

Financial sector stability was maintained. The banking sector is sound with robust capital and liquidity buffers. Regulatory capital to risk-weighted assets stood at 18.1 % in August 2016, above the regulatory minimum. Credit risks are low, as the proportion of non-performing loans, which are fully covered by bank provisions, is the lowest in the region and fell to 5.1 % by August 2016, due in part to private loan enforcement agents' activities.

Access to finance

Kosovo's financial markets rely on traditional bank lending, while other sources of financing remain underdeveloped. Kosovo's financial system is dominated by the banking sector which takes up 69.0 % of the total financial sector assets. The banking sector remains largely foreign-owned (89.9 %). Total assets in the financial system grew by 8.1 %, standing at 86.0 % of GDP in 2015 and lending activities accelerated compared to the previous year (7.3 % growth in total loans). Although total lending grew, the low loan-to-deposit ratio increased only slightly to 74.8 % from 74.2 % in 2014 showing ample room for stronger banking activity. The average interest rate on loans decreased in 2015 to 7.7 % from 9.3 % in 2014 but remains above the regional average.

ERP policy guidance: Further address the underlying legal and institutional factors responsible for both high cost of credit and difficulties in access to finance so as to increase financial intermediation in the economy, while establishing a reliable measure of private sector inflation expectations so as to better gauge price developments.

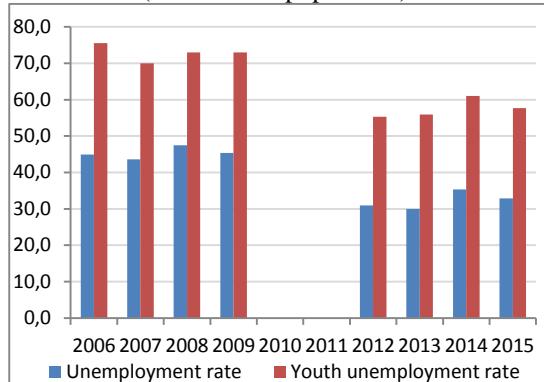
The insurance sector is dominated by non-life insurance companies and the industry continues to generate losses. The cost of car insurance is artificially high, due in part to Kosovo not being a member of the 'green card' system, but also to it not having fully liberalised third party liability insurance prices. A new law on insurance was adopted in December 2015, but supervision in this sector is still weak. Transparency needs to be improved by publishing annual reports, improving the reliability of audits of qualified financial statements, and by applying strict standards for licencing new companies.

Functioning of the labour market

Employment is extremely low and efforts to improve labour market conditions so far have been limited and ineffective so far. Moderate economic growth over recent years has not translated into better performance in the labour market. According to the 2015 labour force survey, the labour participation rate remains exceptionally low at 37.6 %.

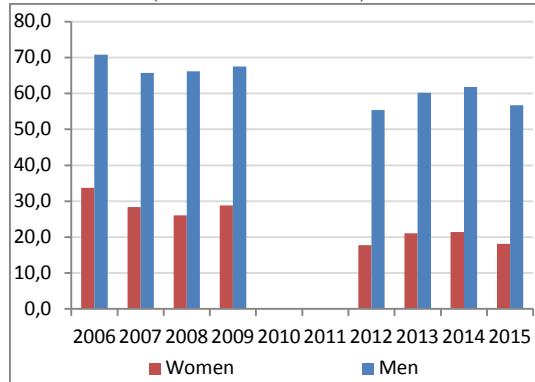
ERP policy guidance: Set up an action plan for tackling youth unemployment based on an assessment of the challenges and focussing on improving education outcomes including through improved teacher training and supporting school-to-work transitions. Ensure that the Employment Agency has sufficient capacity. Take measures to increase labour market participation of women.

Graph 33: Unemployment in Kosovo
(% of Active population)



* Figures for 2010 and 2011 are not available

Graph 34: Participation rates in Kosovo
(% of Labour Force)



Unemployment decreased to 32.9 %, and remains among the highest in Europe. The labour market outcomes for women are particularly weak (only 18.1 % of women are active and 36.6 % of these are unemployed). The share of unskilled workers among the total unemployed (57.1 %) and high youth unemployment (57.7 %), demonstrate the urgent need for more active labour market policies, prequalification schemes and vocational training programmes. The narrow production base offers limited employment opportunities, especially in combination with poor education results mismatched with the demands of the labour market. On the other hand, Kosovo does not have a problem with labour protection legislation, taxation or a social welfare system disincentivising work. There is, however, evidence that a high reliance on remittances discourages employment.

Funding for employment services and vocational training remains insufficient and is also fragmented across several entities. The announced plan to merge them under the new Agency for Employment has yet to be implemented. Statistics regarding the labour market are inadequate and outdated, hampering a sound analysis of the labour market.

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

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

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

- securing a stable energy supply, reducing distribution losses and improving energy efficiency measures;
- closing the skills gap in the labour market;
- implementing the action plan of the national strategy for the fight against the informal economy;
- setting up an action plan for tackling youth unemployment and focusing on improving education outcomes.

Education and innovation

Education, research and development are hampered by insufficient public spending, poor cooperation between vocational schools and enterprises, as well as delays in the implementation of policies to bridge the skills gap. In 2015, total public spending on education declined to 3.9 % of GDP, from 4.1 % of GDP in 2014, which is broadly in line with middle income countries with similar age profiles. However, considering the large number of students, Kosovo spends considerably less than some neighbouring countries per student in primary and secondary education. Furthermore, 75 % of overall spending on education is for salaries and increases in education spending are used almost entirely for salary increases rather than education quality improvement (only 0.2 % of education spending was appropriated for training of teachers). The attendance rates in pre-school and pre-primary education are still very low (3.7 % and 74 % respectively) undermining efforts to create a level playing field for the beginning of primary school. Kosovo participated in the PISA¹ assessment for the first time in 2015, but results will only be available at the end of 2016. Public spending on research and innovation amounted to only 0.05 % of GDP out of which only one fifth was allocated to scientific research and grants.

Attempts to address the evident skills mismatch in the labour market have so far not been effective in producing results. The implementation of the adopted 2016-2020 strategy for quality assurance in pre-university education in Kosovo will depend on stable and adequate financial and committed human resources. Some 40 % of graduates with a vocational diploma and 35 % of graduates with a university degree do not have the necessary skills demanded by the labour market. Vocational education and training programmes are poorly coordinated, lack appropriate strategies and priorities, and do not reinforce Kosovo's economic development strategies.

Physical capital and quality of infrastructure

Kosovo made some progress in improving its physical capital, but bottlenecks in the energy sector remain unaddressed. In 2015, Kosovo established the National Investment Committee and prepared a Single Project Pipeline (SPP) to prioritise future major infrastructure projects. The SPP should become a key planning tool for Kosovo's public investments. In 2015, the share of investment spending in the budget continued to decrease, reaching 25.8 %, down from 38.2 % in 2011. Most capital spending was on roads, with the Route 6 project taking up 35.1 %. The weak implementation of donor financed projects highlights institutional deficiencies and capacity constraints at both central and local government level.

Kosovo's unreliable energy supply is the biggest obstacle for development. High distribution losses in the electricity network and low energy efficiency further undermine energy security. Although investments in the electricity network have improved its stability and reduced technical losses to some extent, they lag behind initial plans. The construction of the new 400kV transmission interconnector with Albania was finalised on the Kosovo side. Negotiations for the construction of the new lignite power plant are still on-going.

ERP policy guidance: Increase energy security by reinforcing the planned energy efficiency measures to include incentives for the private sector and households and by adopting a plan for the gradual adjustment of energy tariffs to reflect actual costs.

The railway sector is plagued by the weak administrative capacity of regulatory institutions and the poor state of infrastructure. The project to rehabilitate the railway from Pristina to Mitrovica has now been confirmed. Investments in large highways to Tirana and Skopje deprived local roads of funding needed for proper maintenance and improving safety standards. This could cause infrastructure to deteriorate faster, and generate higher maintenance costs in the future. The planned EUR 409 million investment in the Brezovica ski resort failed due to the inability of the investment consortium to secure the required investment funds. The digitalisation of the economy is slowly advancing: internet

¹ OECD's Programme for International Student Assessment

penetration per household reached 75.5 % and internet penetration per user increased to 12.35 % compared to 10.51 % in 2014.

Sectoral and enterprise structures

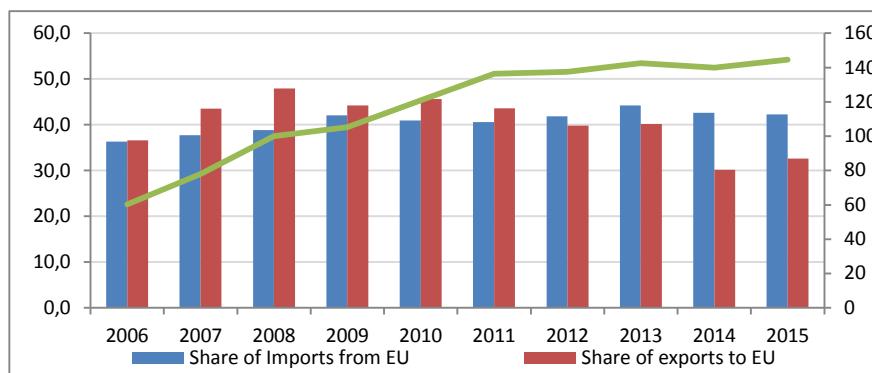
There was no progress in addressing the structural weaknesses of Kosovo's private sector, which continues to be fragmented and unable to improve its efficiency. There have been no significant structural changes in Kosovo's economy since 2008. The agriculture sector contributes 13.5 % of the gross value added (GVA) (compared to 17.5 % in 2008), is responsible for 26.7 % of total employment and provides about 12 % of the total value of exported goods. Productivity gains in agriculture are limited by the relatively small size of land plots, poor access to broader markets and a lack of investment in new technologies. The share of mining, manufacturing and construction sectors is stable at around 28 % of GVA, but exports are dominated by low value-added basic processed metal products and scrap metal. The share of the services sector rose to 59 % of GVA (compared with 55 % in 2008), centred around the trade, finance and IT sectors. However, compared with the average of developed countries Kosovo's economy is still lagging in terms of sector diversification.

Micro, as well as small- and medium-sized enterprises (SMEs) continue to account for 99 % of total employment. The largest number of enterprises operate in the trade sector (29.9 %), followed by accommodation, food services and industry. In January 2016, the new law on the Credit Guarantee Fund entered into force with the aim of improving access to finance for SMEs. A credit guarantee scheme was launched in April 2016 with a contribution from the Kosovo budget of EUR 3 million.

Economic integration with the EU and price competitiveness

The recent adoption of the SAA will substantially improve Kosovo's trade and investment integration with the EU. Kosovo's economy is still relatively un-integrated in global trade flows, with a trade openness of 71.4 % of GDP. The majority of Kosovo's exports consist of raw materials, basic metal products and scrap metal. The EU is Kosovo's biggest trade partner with 41.9 % of overall trade in 2015, followed by the Central European Free Trade Agreement - CEFTA (30.2 %). In spite of the increase, Kosovo's total trade volume with the EU remains very limited, reflecting the low competitiveness of its products and poor access to bigger markets. The implementation of the SAA offers significant opportunities to improve access and competitiveness of Kosovo's firms in the EU single market. EU Member States are the biggest foreign investors in Kosovo (50.9 % of overall FDI since 2007). Most of the FDI coming from the EU is concentrated in the financial, trade and real estate sectors.

Graph 35: Kosovo trade integration with the EU



7.3. CONCLUSIONS

As regards the **economic criteria**, Kosovo is at an early stage in developing a functioning market economy. Some progress was made, particularly on supporting export-oriented businesses, improving contract enforcement, especially within the financial sector, and access to finance. However, the fiscally unsustainable decisions related to war-veterans' benefits may have a negative effect on the macroeconomic stability of Kosovo and its relations with international financial institutions. The persistent trade deficit reflects a weak production base and poor international competitiveness. Reliance on remittances and the widespread informal economy additionally decrease employment incentives, resulting in low labour force participation, especially among women, and high unemployment rates, in particular among young and unskilled workers.

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

ABBREVIATIONS

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

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