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From:	General Secretariat of the Council
To:	Delegations
Subject:	EU Candidate and Potential Candidate Countries' National Economic Reform Programmes 2016: Review and Assessment of Monetary and Exchange Rate Policies

In view of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey of 25 May 2016, delegations will find attached

"EU Candidate and Potential Candidate Countries' National Economic Reform Programmes 2016: Review and Assessment of Monetary and Exchange Rate Policies"

EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-RESTRICTED
18 April 2016

EU Candidate and Potential Candidate Countries' Economic Reform Programmes 2016:

Review and Assessment of Monetary and Exchange Rate Policies

Prepared by ECB staff for the Economic Dialogue with EU Candidate and Potential Candidate Countries Spring 2016

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Introduction

This report[1] reviews and assesses monetary and exchange rate policies in five of the six EU candidate countries, namely Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey, as well as the two EU potential candidate countries Bosnia and Herzegovina and Kosovo.[2] It is based on the 2016 Economic Reform Programmes (ERP) prepared by these seven countries, which outline the main economic policy developments and objectives over the medium-term.

The report is the ECB's contribution to the Economic Dialogue with the candidate and potential countries established by the ECOFIN Council in 2001. In line with the consultative nature of this dialogue, the ECB's assessment does not prejudge any subsequent policy positions that may be taken at a later stage, in particular in the context of future convergence reports.

As in previous years, the ECB assessment focuses on monetary policies and related exchange rate issues while also touching on fiscal policies and financial stability, due to their impact on monetary policy making. Monetary and exchange rate policies are crucial in pursuing the goal of price stability, anchoring inflation expectations, thereby providing a framework that fosters macroeconomic and financial stability.

Following a brief overview outlining key recommendations, the remainder of the report is organised in country chapters. Each chapter is structured as follows: Section 1 recalls the main elements of the prevailing monetary and exchange rate policy frameworks, while Section 2 reviews recent economic and financial developments. Section 3 provides a short assessment of the framework and presents recommendations. A data appendix providing an overview of selected indicators, with particular relevance to the conduct of monetary and exchange rate policies, is reported at the end of the document.

[1] The data in the report have end-March 2016 as cut-off date.

[2] This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

Overview and key recommendations

Economic activity recovered across prospective EU member countries in 2015. The pace of economic activity accelerated in all cases relative to 2014, and the divergence in individual economic performance across countries was also reduced (see Chart 1). However, the expansion in real GDP turned out to be less dynamic than initially envisaged in a majority of countries under consideration, in part due to a more protracted recovery in the external environment than previously foreseen. This also meant that progress towards rebalancing the sources of growth was generally limited, with domestic demand (and in particular investment) remaining the key driver of economic activity in most cases.

Inflationary pressures have continued to remain subdued, especially in countries that use the exchange rate as a nominal anchor (see Chart 2). Inflation in 2015 continued to be weighed down by declines in food and energy prices amid low imported inflation from the euro area. As was already the case in 2014, countries which either peg to the euro or do not have their own separate legal tender saw their headline inflation rates remaining in negative territory on an annual basis (except Montenegro), while inflation targeting economies experienced positive if below-target inflation. Turkey was again an exception to this trend, with inflation continuing to remain high and above target and thereby continuing to warrant a tighter monetary policy stance than that pursued by the central bank.

The fiscal position improved in most cases, but public debt dynamics have yet to stabilise. Fiscal deficits in 2015 narrowed relative to end-2014 outcomes in all cases except Montenegro (see Chart 3), in some cases partly reflecting intended or unintended reductions in capital expenditures amid a generalised upturn in economic activity. While fiscal performance turned out to be more positive than authorities had initially foreseen in Albania, Serbia and Bosnia and Herzegovina, this was not the case elsewhere, especially in Montenegro and (to a lesser extent) in the former Yugoslav Republic of Macedonia. Public indebtedness levels edged up only slightly in relation to GDP in most countries under consideration - except in Montenegro where the growth of public debt remained unabated - but have yet to show signs of stabilisation and remain elevated in most cases.

Regarding constraints on monetary policy making, fiscal factors have tended to ease, but progress in reducing liability euroisation in banking systems has been only gradual. Fiscal consolidation in 2015 created room for central banks to step-up the degree of monetary policy easing in Serbia and to a lesser extent in Albania. Monetary policy remained accommodative (but was not eased de jure) in the former Yugoslav republic of Macedonia, in spite of fiscal slippages by authorities. However, some central banks continued to be on the receiving side of government transactions related to an increased reliance on external sources of funding for deficit financing, entailing operational consequences for monetary authorities via sterilisation. Constraints to the efficiency of central banks' monetary policy stemming from the degree of liability euroisation in the banking system also remained elevated, with the share of fx-denominated in total loans decreasing only slightly (if at all) in most country cases.

External imbalances tended to narrow, although sizeable vulnerabilities persist. Current account deficits in 2015 narrowed with respect to end-2014 levels in all cases except Kosovo and the former

Yugoslav Republic of Macedonia. The reasons behind this trend were heterogeneous across countries, including narrower merchandise trade deficits on account of improved export performance and lower oil prices, higher surpluses on the services account (mostly reflecting improved tourism receipts), and in a few cases higher secondary income inflows. However, external imbalances continue to give grounds for concern in many cases (see Chart 4).

Non-performing loan burdens on banks' balance sheets have moderated only slightly. The ratio of non-performing to total loans in 2015 slightly edged down relative to 2014 in all countries except in the former Yugoslav Republic of Macedonia and Serbia. However, NPL ratios still remained close to post-crisis peaks (and at elevated levels) in many cases (see Chart 5), contributing to very uneven credit dynamics across countries. The extent to which new policy initiatives have been undertaken in response to this long-standing challenge has varied across countries, with authorities in Albania and Serbia taking the most ambitious steps.

With the above in mind, the **key recommendations** put forward for prospective EU members in 2016 can be broadly grouped around the following five themes.

First, comprehensive NPL resolution strategies involving relevant stakeholders should be adopted in order to mitigate risks to both financial stability and the real economy. The persistence of sizeable non-performing loan burdens on banks' balance sheets represents a continued challenge to financial stability through (reduced) bank profitability as well as a supply-side bottleneck to credit extension. Coupled with other structural factors, impaired loans also dampen the transmission of monetary impulses by the central bank and thus compromise the efficiency of monetary policy. For these reasons, the disposal of bad loans by banks and the related need for corporate restructuring continues to demand the attention of policymakers in Western Balkan economies. Looking forward, those countries suffering from sizeable NPL burdens which have not yet adopted a comprehensive NPL resolution strategy (i.e. Bosnia and Herzegovina, former Yugoslav Republic of Macedonia and Montenegro) would benefit from the development of such a plan tailored to local circumstances, as has been done in Albania and Serbia. In the latter two cases, the challenge in the period ahead will be to follow-up with the implementation of the measures which have been previously outlined.

Second, strategies to promote the use of local currencies in financial systems should be developed with a view to increasing the degrees of freedom available to monetary policy authorities and fending off financial stability risks. As with the case of NPLs, a reduction in asset and liability euroisation in banking systems of those prospective EU member countries in the Western Balkans with a separate legal tender should be net positive for both financial stability (reducing risks to banks through unhedged borrowers in the event of currency depreciation) and the conduct of monetary policy (by reducing policy tradeoffs and improving the efficiency of the monetary transmission mechanism). While several individual measures have been taken in recent years to encourage the use of local currencies in financial systems, the present environment of low interest rates on euro deposits (on the side of banks' liabilities) and declining interest rates on local-currency denominated instruments (on the side of banks' assets) would seem ripe to develop a broader approach towards this question, involving both governments and central banks. The development of such a strategy would thus be welcome in

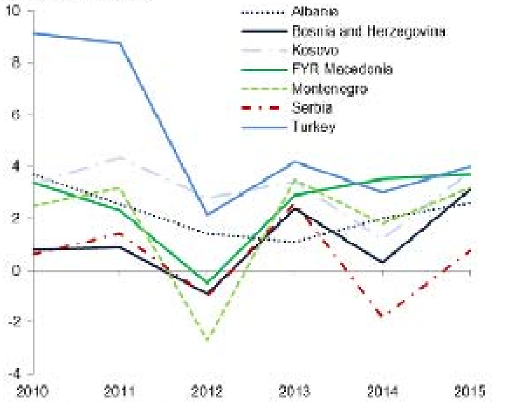
Albania and the former Yugoslav Republic of Macedonia, while consideration could also be given to enhancing Serbia's dinarisation strategy.

Third, analytical and policy tools of central banks should continue to be enhanced. Many authorities in the Western Balkans region have embarked or are planning to embark on a process of reviewing their macro-prudential and bank resolution frameworks. This effort should be welcome from the point of view of both buttressing the resilience of the banking sector itself and seeking as close an alignment as possible with the applicable EU standards which will subsequently become binding upon accession. In addition, the upgrade of other analytical and policy tools at the disposal of the central bank consistent with this dual objective should also be pursued, including the development of inflation expectations and lending surveys for those central banks which still lack them.

Fourth, consolidation and medium-term orientation of fiscal policy should be reinforced, including through credible rules-based frameworks. Cementing the medium-term orientation of fiscal policy remains a broad-based challenge for prospective EU member countries in the Western Balkans. In highly-indebted countries such as Serbia and Albania, the key challenge remains to put debt dynamics on a firm downward path, building on the recent improvement of the fiscal stance, while developing a credible rules-based framework to anchor policy beyond the lifetime of the IMF programmes in place. In Montenegro, there is a pressing need to redress the current direction of fiscal policy so as to avoid the materialisation of potentially adverse feedback loops between growth, debt dynamics and the public balance sheet going forward. A tighter fiscal stance also appears warranted in the former Yugoslav Republic of Macedonia in order to ensure that medium-term budgetary objectives are met. The development of enforcement mechanisms consistent with the fiscal objectives that authorities have set for themselves under the existing rules-based frameworks continues to deserve attention in Montenegro, the the former Yugoslav Republic of Macedonia and Kosovo. Overall, the building of policy buffers to accommodate potential negative shocks appears as particularly important in countries which have limited or no degrees of freedom in the conduct of monetary policy, with fiscal policy thus remaining the main tool for short-term stabilisation purposes. Sustained fiscal consolidation would also create room for central banks to act on price developments should circumstances warrant.

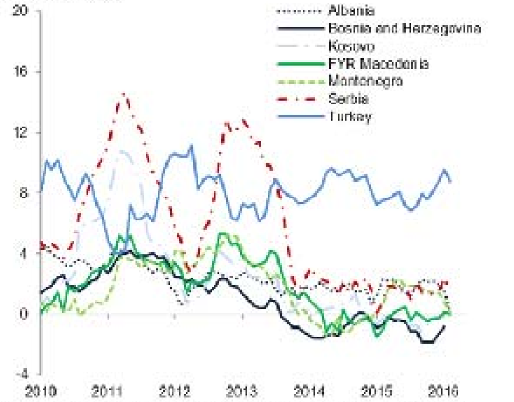
Fifth, improvements to the overall business and institutional environment should continue to be sought so as to foster economic activity, a more diversified growth model and a reduction in external vulnerabilities. The high external imbalances which persist in many prospective EU member countries point to continued competitiveness weaknesses and narrow productive bases, thereby putting a lid on growth. Sustained improvements in the overall business and institutional environment - which remains heterogeneous across countries (see Chart 6) - should be associated with a medium-term reduction in 'structural' trade and current account deficits, with higher foreign investment in the tradable sector contributing to a lower drag from net exports. In turn, this should also allow for a more diversified economic model through a greater contribution of the private sector to growth. This is a broad-based challenge for all prospective EU members in the Western Balkans but appears especially pressing for those countries whose monetary frameworks prevent them from using the exchange rate as a shock absorber.

Chart 1. Real GDP growth
(y-o-y, in percent)



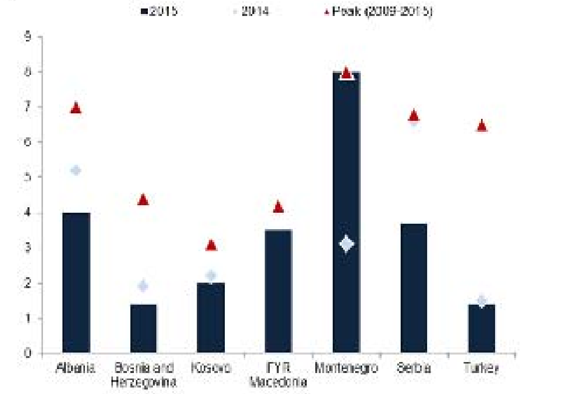
Notes: Figures for 2015 are ERP estimates in the case of Kosovo.
Sources: National authorities.

Chart 2. Consumer price inflation
(y-o-y change)



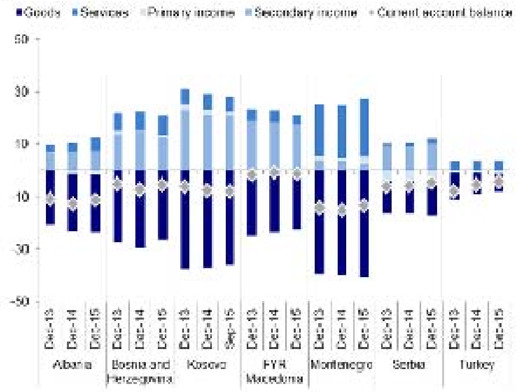
Sources: National authorities, Haver Analytics and ECB staff calculations.

Chart 3. General government fiscal balance
(percent of GDP)



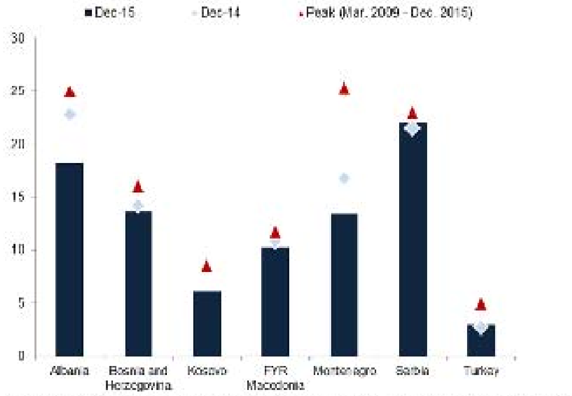
Notes: Figures for 2015 are estimates from the ERP in the case of Bosnia and Herzegovina and Kosovo, and EC Winter Forecast 2016 for Turkey. National data for the remaining countries.
Sources: European Commission and national authorities.

Chart 4. Current account balance
(percent of GDP)



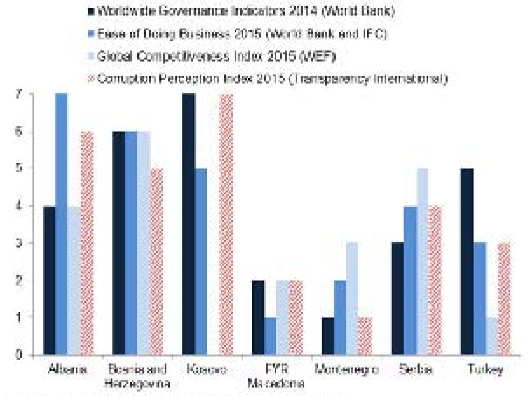
Note: 4 quarter moving sum. September 2015 in the case of Kosovo since Q4 2015 GDP data has not yet been released.
Source: National authorities, Haver Analytics and ECB staff calculations.

Chart 5. Non-performing loans to total loans
(percent of GDP)



Note: Definition of NPLs may differ in between countries. September 2015 last data point for Serbia.
Sources: National authorities, Haver Analytics and IMF/IFS.

Chart 6. Structural and governance indicators
(in percent)



Note: Countries are ranked from 1 (best) to 7.
Sources: Haver Analytics, Transparency International, World Bank, WEF and ECB staff calculations.

Albania

1. Monetary and exchange rate policy framework

The Bank of Albania's (BoA) primary objective is to achieve and maintain price stability. Without prejudice to its primary objective, the BoA also serves as the banking supervisory authority and contributes to the maintenance and strengthening of the stability of the overall financial system.

The BoA aims to achieve price stability through an inflation targeting framework, where the inflation target is defined in terms of annual percentage changes in headline inflation as measured by the consumer price index. The targets, announced for several years ahead, are defined as point targets. The BoA has set the inflation target until end-2018 at the level of 3.0%. The key interest rate is the weekly repo rate, which also serves as the reference rate for other monetary policy instruments such as standing facilities, additional liquidity-providing operations and required reserves. The operational objective is to steer short-term interbank rates close to the key interest rate and to minimise their volatility. To comply with this operational objective, the BoA intervenes in the money market injecting liquidity via reverse repo agreements with maturity of 7 days, 1 month and 3 months.

Consistent with the inflation targeting framework, the BoA implements a free-floating exchange rate regime. The central bank intervenes in the fx market essentially to smooth short-term exchange rate volatility; interventions do not aim to affect the exchange rate path. Consistent with its monetary policy, and based on the observance of two main quantitative criteria[3], the BoA is also committed to holding a sufficient level of foreign reserves.

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

Economic activity accelerated in 2015, supported by strong investment. The pick-up in economic activity was partly driven by strong investment growth; in turn reflecting higher FDI as well as an improved liquidity position of the corporate sector due to the repayment of arrears by the government (see Chart 1). Despite turning positive in the second half of the year private consumption contributed overall slightly negatively to growth, as was also the case for public consumption due to consolidation efforts by the government. Net exports were the other positive contributor to growth, contrary to what was the case in 2014. Turning to a sectoral breakdown of real activity, strong investment was mainly reflected in construction, which expanded by 15% in year-on-year terms until September, while industrial production stayed in negative territory amid poor export performance. Overall, real GDP increased by 2.6% in 2015 as was foreseen in the ERP.

[3] The Monetary Policy Document of January 2015 indicates that "Bank of Albania will aim at holding a sufficient level of foreign reserve for the concurrent observance of the following two quantitative criteria: (1) the foreign reserve levels should be sufficient to cover at least 4 months of imports of goods and services in the medium run; (2) the foreign reserve levels should be sufficient to cover the short-term external debt of the Albanian economy in the medium run.

The outlook for 2016 remains favourable but risks appear tilted towards the downside. Growth is anticipated to accelerate further still driven by domestic demand. According to the baseline projected in the ERP, gross fixed capital formation (i.e. public and private investment) is anticipated to rise by 9.1% each year from 2016-2018, driven mainly by two large energy projects, namely the Trans-Adriatic Pipeline (TAP) and Statkraft-Devoll Hydropower. Private consumption is expected to be supported by higher consumer confidence, a pick-up in credit growth, and improvements in the labour market, respectively. Although exports of goods and services are forecasted to perform well – especially in the tourism sector – net exports are nevertheless projected to contribute negatively to growth due to higher import needs related to infrastructure projects. Overall, the ERP foresees real GDP growth to expand by 3.4% and 3.9% in 2016 and 2017 respectively, with the forecast by the EC slightly lower in comparison[4]. Risks to this outlook appear tilted towards the downside on account of both external and domestic factors. On the external front, these include more sluggish recovery than currently foreseen (especially in key trading and investment partners such as Italy and Greece) as well as a subdued outlook for international oil prices (given Albania's status as a net exporter of crude oil). Downward risks to the outlook on the domestic front include a protracted under-execution of public capital expenditures, and weaker-than-expected improvements in private consumption and labour markets, respectively.

Increased tourism receipts and higher remittances have led to an improvement in the current account balance, but the trade deficit has remained very large. The current account deficit narrowed to 11.2% of GDP in 2015, from 12.9% of GDP in 2014, largely on account of a more dynamic contribution from the service balance (higher tourism revenues as well as a contraction of service imports). A slight pick-up of remittances also contributed to this outcome. However, the improvement in the current account balance was dampened by the sizeable merchandise trade deficit, which widened to 22.3% of GDP amid the related fall in Albania's crude oil exports[5]. Overall, the current account deficit amounted to 11.2% of GDP in 2015 as a whole, as compared to 12.9% in 2014 (see Chart 2). Looking ahead, the ERP anticipates a flat development in 2016 and a slight widening of the current account balance to 12.4% of GDP in 2017, consistent with both the projected increase in FDI and the higher machinery imports and increased primary income outflows which would be associated with this trend (see also below).

Though foreign direct investment has been on the rise, it remains concentrated in a few sectors and thereby contributes to lingering external vulnerabilities. Net FDI increased by a strong 7.3% in 2015, amounting to 8.4% of GDP, driven by the two large investment projects, while net portfolio investment turned positive following the government's EUR 450mn Eurobond issuance of November 2015 and a divestment of domestic banks into foreign debt securities. Looking ahead, in line with the two large energy projects the BoA projects further increases of FDI, with net FDI edging up to 11% and 12% of GDP in 2016 and 2017 respectively. However, Albania's narrow FDI base (and its sensitivity to changes in international energy prices) will continue to challenge the sustainability of external balances if left unaddressed. A broadened FDI base which helps to keep external vulnerabilities in check also

[4] The EC projects 3.2% growth for 2016 and 3.5% for 2017, while the IMF forecast is in line with the ERP.

[5] According to the Albanian authorities, crude oil exports fell by 46% in value and by 11% in volume the first nine months of 2015.

appears important in light of rising total external indebtedness, which edged up to 73.9% of GDP in 2015, largely due to increased borrowing from abroad by authorities.

Chart 1. Contribution to real GDP growth
(annual percentage change in real GDP)

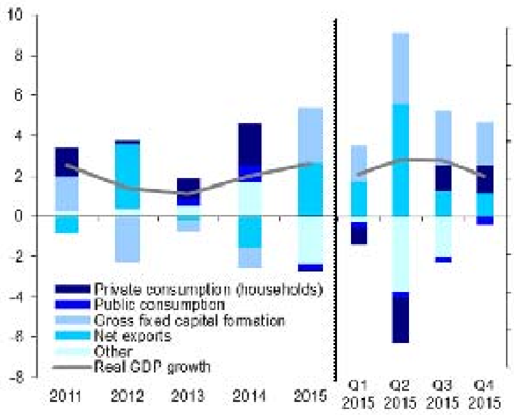
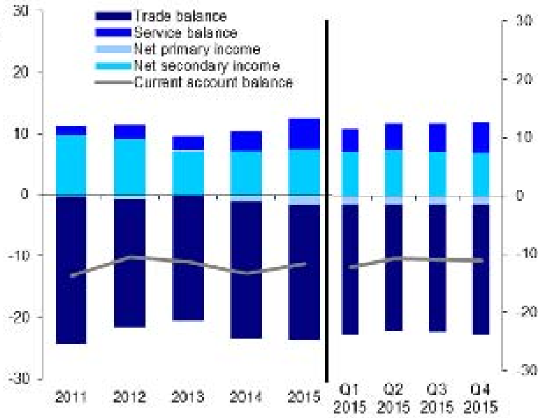


Chart 2. Components of the current account balance (in % of GDP)



Notes: Quarterly figures for the current account balance are a moving sum of the most recent four quarters. In the case of contributions to real GDP growth, the graph shows annual growth with respect to the same quarter a year earlier.
Sources: Bank of Albania, Haver Analytics and ECB staff calculations.

A shortfall of fiscal revenues was more than offset by expenditure cuts, leading to a better-than-expected fiscal outcome. Factors which led to the shortfall in revenues included lower-than-expected GDP growth and lower oil prices than initially foreseen, but also forecasting errors by domestic authorities. This was more than offset by a reduction in capital expenditure which could at least partly be deemed as an 'accidental' outcome rather than 'conscious' effort due to doubts over project implementation capacity. Other sources of expenditure-based fiscal consolidation stemmed from a reduction of current expenditures as well as from decreasing borrowing costs amid a low interest rate environment. Overall, the fiscal deficit for 2015 met the deficit target of 4% of GDP (see Chart 4), which is in lower than the initially envisaged target for 2015 under Albania's Fund-supported programme (4.8% of GDP[6]).

Authorities plan for further fiscal consolidation in the years ahead. The headline deficit target for 2016 has been set at 2.2% of GDP (corresponding primary surplus at 0.6% of GDP); thereafter, the ERP foresees a gradual reduction in government deficits over time to a low of 0.5% of GDP in 2018. Consolidation for 2016 foresees measures on both revenues (notably the fight against informality and a broadening of the tax base) as well as expenditures (stemming mainly from the full clearance of arrears to the private sector). Under the baseline scenario depicted in the ERP, the level of public debt is thus projected to have peaked at 73% of GDP in 2015 and thereafter anticipated to follow a steady downward path to below 64% in 2018. Risks to this fiscal baseline appear tilted towards the downside and have to do with a less dynamic pace of economic activity than currently foreseen as well as from a more protracted progress in key reforms (local governments, property compensation claims, and energy

[6] Corresponding to the target from the second and third reviews of the programme, which were compiled at the beginning of 2015.

reform) which would imply higher-than-currently-foreseen outlays for the public balance sheet. The possibility of higher outlays materialising due to a change in the main 'transit' migration route from third countries to the EU (which would see migrants going through Albania in greater numbers than has been the case until now) constitutes a further downside risk in this regard.

Chart 3. Exchange rates and foreign exchange reserves

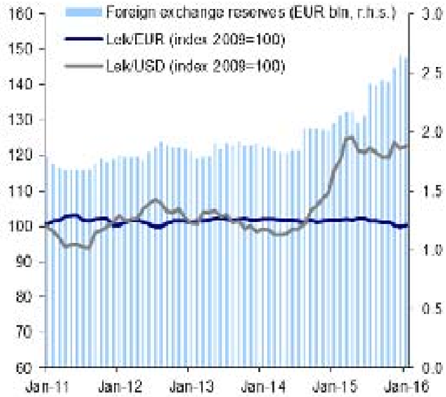
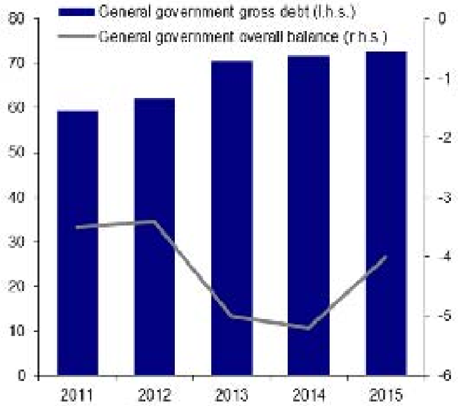


Chart 4. Government gross debt and balance
(in % of GDP)



Sources: Bank of Albania, Albanian Ministry of Finance (figures for 2015 are estimates from ERP), Haver Analytics and ECB staff calculations.

Increased reliance on external sources of finance for deficit financing has helped to reduce rollover risks for authorities at the expense of increasing potential vulnerability to changes in foreign investor sentiment. The share of domestic debt in total debt for the central government has decreased to 53.0% in 2015 from 58.8% by end-2014, with excess proceeds from the November 2015 Eurobond being used to buy back domestic debt. Within the domestic segment, authorities have been increasing share of long-term instruments through seven-year and ten-year bond issuances. Rollover risks for of the government have been reduced and incipient concerns on whether domestic banks' sizeable exposure to the public sector had reached its limit thereby largely dissipated. However, the rebalancing of the public debt stock towards increased external indebtedness renders the sovereign more vulnerable to sudden shifts in investor sentiment through exchange rate and interest shocks. For example, an estimated 1 percentage point out of a 6.5% increase of the debt stock of 2015 can be traced back to the depreciation of the Lek against the USD (see Chart 3).

2.2 Inflation, exchange rates, monetary policy and financial stability

Price dynamics remained subdued. Inflation was well below the 3% target, with an average inflation rate of 1.9% and an end of period rate of 2.0% in December (see Chart 5). Weak price dynamics reflect unutilised production capacities and subdued domestic demand, but also low imported inflation from main trading partners as well as from the downward trend in international commodity prices. Inflation expectations of all economic agents also remained below target in 2015 and tended to follow a downward path. Looking forward, the BoA expects inflationary pressures to remain subdued in the short-run, with average inflation projected at 2.2% for 2016 as a whole and headline CPI not seen to return to target until 2018. Risks to inflation appear tilted towards the downside, consistent with the balance of risks for economic activity going forward, including through further potential decreases in commodity prices and a weaker recovery than currently expected in main trading partners, which will also impinge on domestic output growth.

Chart 5. Consumer price inflation and BoA policy rate
(annual percentage change)

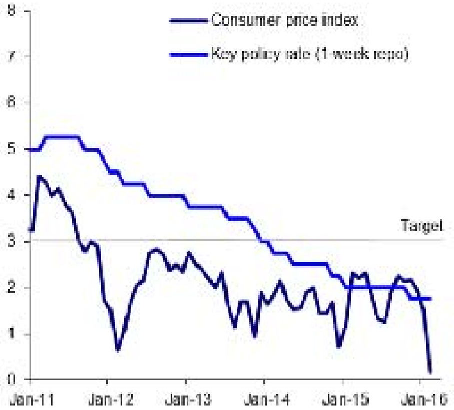
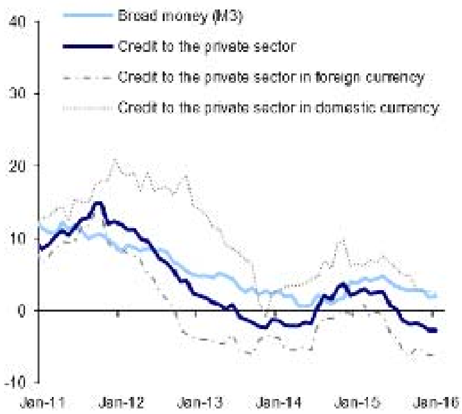


Chart 6. Money and credit growth
(annual percentage change)



Sources: Bank of Albania, Haver Analytics and ECB staff calculations.

The Bank of Albania has maintained an accommodative monetary policy stance in a bid to support both credit and economic activity, though with only limited success. Amid subdued inflation and output below potential, the BoA has maintained an accommodative monetary policy stance, bringing down the key policy rate to a historic low of 1.75% as of November 2015. In addition, the BoA continued to engage in forward guidance by communicating that low policy rates will prevail until inflation is back to target in a sustained manner and also decided to prolong for another year the temporary counter-cyclical macro-prudential measures to support credit growth which were originally introduced in 2013. Taken together, these measures appear to have had some traction on the ground, for example to foster lending in Lek with rates on new loans easing somewhat in the second half of 2015. Lending dynamics showed diverging trends across market segments, with credit activity to households remaining positive throughout 2015, but that to corporates turning negative as of 2015H2 on account of NPL write-offs. Overall, while the change of nominal credit activity to the private sector has been negative (-2.6% at the end of 2015 in a year-on-year comparison), adjusting for the total NPL write-offs of Lek 27 bn reveals a real increase of credit activity by 2.3% during the same period. A number of factors appear to continue to weigh down on credit extension including risk aversion by euro area headquartered banks, high NPL burdens on banks' balance sheets, tight credit standards[7], and subdued domestic demand for credit in a context where corporate liquidity has improved following the repayment of arrears by the public sector.

[7] According to the bank lending survey credit standards eased from the second quarter on (both for households and for enterprises) but stayed overall tight, with NPLs being one of the main factors behind the tightening of credit standards.

The impact of government transactions stemming from the way in which the fiscal deficit is being financed, risks affecting the signalling power of BoA monetary policy. The authorities' decision to make growing use of external sources of funding to finance government deficits has affected liquidity conditions for domestic banks, with the system as a whole being less in deficit than hitherto. Increased bank liquidity and reduced supply of government securities in a domestic context has driven down domestic government bond yields, including those at the short-end of the curve which are at levels comparable to the BoA key policy rate. While the reduction in short-term government interest rates should be helpful for the monetary policy transmission mechanism (e.g. through its impact on loan pricing), this trend has also been associated with short-term interbank rates drifting below the BoA key policy rate. If protracted in time, the latter development might thus impinge on both the signalling power of the key policy rate and the onward transmission of monetary impulses to the interbank market.

Impairments to the monetary policy transmission mechanism are being addressed through a comprehensive NPL resolution strategy. Challenges to asset quality in banks' balance sheets remain a key impediment for the efficient transmission of BoA monetary policy, an obstacle for stepped-up credit extension, and a threat to financial stability. In recognition of this fact and as follow-up to the 2015 ERP assessment recommendations, the authorities have jointly developed an NPL action plan together with the BoA to facilitate the disposal of bad loans by banks. Legal measures are foreseen to include a new bankruptcy law to facilitate out-of-court restructuring, changes to the civil procedures code and efforts to improve the registration of real estate, which should facilitate collateral execution. On the regulatory side, a limit on the period for banks' holding of seized collateral is envisaged, as well as a case-by-case corporate restructuring of a number of groups/companies being responsible for a substantial volume of NPLs[8] (a measure that should also help financial intermediation) and improvements to facilitate the sale of NPLs (by licensing specialised asset management companies) and additionally to the loan register. Moreover, the planned judicial reform, which should be brought to parliament for approval in spring 2016, will be an important element to improve contract enforcement. While the measures of this ambitious NPL resolution plan are being enacted/implemented, the BoA's introduction in early 2015 of mandatory write-offs of loans that have spent three years in the 'loss' category meant that the ratio of non-performing to total loans decreased to 18.2% in end-2015, from 22.5% at the end of 2014.

The banking system as a whole appears to remain sound, although indirect market risks related to unofficial euroisation, sovereign exposures and challenges to asset quality remain as a latent source for concern. The banking system as a whole continues to exhibit robust capitalisation and liquidity buffers, with capital adequacy ratios at 13.5% and liquid assets to total assets at 32% in end-2015, respectively. Spillovers from financial turmoil in Greece materialising through Greek-owned bank subsidiaries operating in Albania (which together account for around 14% of total banking system assets), were limited in 2015 thanks to prudent regulatory measures undertaken by the Bank of Albania. Risks to banks' funding base remain low, with banks being mostly financed by (admittedly short-term) deposits and a loan-to-deposit ratio of 53% for the system as a whole in end-2015. Bank profitability has also been

[8] One company identified for being responsible for a considerable amount of non-performing loans has already been restructured, having an impact on NPL ratio in December 2015.

improving in recent quarters as measured by standard indicators to this end (return on assets and return on equity). Notwithstanding these positive traits, a number of elements still give cause for concern. First, there remain lingering challenges to bank asset quality which, while declining, remain significant with the ratio of NPLs net of provisions to capital at 24% in end-2015. Second, banks' indirect vulnerabilities to market risks in the event of currency depreciation through potentially unhedged borrowers also remain sizeable, with over half of the total outstanding loan stock still denominated in foreign currency. Third, the exposure of the banking system to the government through holdings of domestic debt securities remains high (accounting for 25% of bank assets in September 2015), though risks are tempered by the fact that the bulk of such holdings are held to maturity. Additionally, in the medium-term risks might emerge from a restructuring of the parent banks of some subsidiaries.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and prospective EU member countries

The 2015 ECOFIN Council conclusions identified a number of areas in need of further policy action by Albanian authorities, including: (i) fiscal consolidation to put the public debt ratio on a downward path, while preserving fiscal space for growth-enhancing public investment; (ii) a reinforcement of the budget management framework by adopting a credible fiscal rule; and (iii) taking further measures to address the issue of NPLs, especially impediments related to judicial enforcement and collateral execution. Relative to this targeted policy guidance, authorities have made progress in fiscal consolidation by further reducing the fiscal deficit for 2015 slightly more than originally envisaged in spite of the fact that real growth turned out to be weaker than expected. However, consolidation came partly at the expense of an under-execution of public investment, since public revenues did not meet their targeted level. Authorities are understood to have drafted a fiscal responsibility law (including a fiscal rule) which has not been sent to parliament yet. Concerning NPLs, authorities have made encouraging progress in the through the adoption of a comprehensive action plan to foster the resolution of bad loans across a number of fronts, which is in its early stages of implementation.

3. Assessment

While real growth turned out to be less dynamic than originally foreseen, the economic momentum finally picked up in 2015, thereby departing from its lacklustre performance in previous years. The economic outlook remains favourable going forward, thus providing an adequate environment for the authorities' ambitious reform efforts in many structural and policy domains (which have gotten off to a promising start) to continue. As the foundations for sustainable long-term growth are being laid, authorities should be mindful of the following:

While the 2015 headline fiscal outcome was positive, efforts should continue so as to ensure that medium-term public finances are firmly placed on a sound footing. The consolidation effort in 2015 was satisfactory, but a number of reforms are necessary to ensure compliance with the consolidation path set out in both the ERP and the programme which authorities have agreed with the IMF. The planned fiscal responsibility law, which entails a new fiscal rule to decrease public debt as well as the setting up of a fiscal council, appears instrumental to this end by providing an anchor for the medium-term orientation of fiscal policy. This appears as particularly important since the large public debt stock has yet to be put on a downward trajectory. Beyond improving revenue projections, elements which appear as essential in the authorities' fiscal strategy going forward include (i) the fight against corruption and the informal economy and (relatedly) the broadening of the tax base, and (ii) more effective management of public investment needs/expenditures so as to buttress the country's capital stock.

The BoA has maintained an adequate policy stance thus far, with room for further policy easing partly contingent on continued progress on fiscal consolidation. The accommodative policy stance pursued by the central bank in 2015 has been appropriate on account of low headline inflation, decreasing inflation expectations by economic agents, sluggish private consumption and subdued credit activity to the private sector, respectively. The broad adherence by authorities to the fiscal targets which they had set for themselves (as well as those inherent in the programme with the IMF) has facilitated this stance by the central banks. Insofar as the BoA expects inflation to reach the target only in the beginning of 2018, there appears to be room for monetary policy stance to remain accommodative in the period ahead conditional on fiscal authorities making further progress on their consolidation efforts. Should circumstances so warrant – for example, in the event that the recovery in the external environment turns out to be more sluggish than currently foreseen – the BoA appears to have some scope for conventional monetary policy easing before turning to the deployment of unconventional policy measures. Risks related to further policy easing should be carefully assessed in a context where sudden adjustments in asset prices (such as the exchange rate) cannot be excluded and asset and liability euroisation in the economy remains high. Should changes to the BoA law be considered as part of the legislative process going forward, it would be important that such changes go in the direction of cementing the independence of the central bank.

The effective implementation of the NPL action plan appears crucial on both financial stability and real economy considerations. The comprehensive NPL action plan developed by authorities in 2015 is an encouraging step in the right direction. The success of this ambitious and multi-faceted strategy will only become apparent over time, such that the implementation of its many aspects in a time-consistent manner will be key. The timely preparation of the new draft of the bankruptcy law, which is one of the cornerstones of the authorities' NPL resolution plan and whose submission is scheduled for June 2016 as detailed in the ERP, will thus be an important bellwether to ascertain that authorities' reform efforts in this domain remain on track. Other important elements in this regard include the improvement of the legal framework for asset management companies, the restructuring of individual companies and the planned judicial reform.

A comprehensive strategy to promote the use of the local currency in the banking system would help to reduce tail risks to financial stability as well as provide greater degrees of freedom for the conduct of monetary policy. In spite of de facto nominal exchange rate stability and low and stable inflation in recent years, the degree of euroisation has decreased only slowly over time on the side of banks' assets, and even exhibited an increasing trend on the side of banks' liabilities. This feature continues to limit the degrees of freedom available to authorities for the conduct of monetary policy, hampering the efficient functioning of the monetary policy transmission mechanism, while posing a threat to financial stability through indirect market risk in the event of unforeseen 'tail events'. While recognising that unofficial euroisation in banking systems is partly driven by (often exogenous) factors which lie outside the full control of domestic authorities, a joint strategy between the government and the BoA should be helpful to promote the use of the local currency in both the banking sector and the financial system more broadly. The timing for the development of such a strategy appears ripe on account of both the low interest rates on euro-denominated deposits (on the side of banks' liabilities) and the gradual decrease in interest rates on Lek-denominated loans (on the side of banks' assets). An integral approach to promote the use of the local currency would also be mindful of the potential benefits that the development of local currency capital markets would have in terms of improving access to finance for both corporates and banks themselves, while being mindful that such benefits are likely to accrue only slowly over time.

Bosnia and Herzegovina

1. Monetary and exchange rate policy framework

The main objective of the Central Bank of Bosnia and Herzegovina (CBBH) is to achieve and maintain the stability of the domestic currency under a currency board arrangement, with the euro as the anchor currency. The CBBH issues the domestic currency (convertible Marka, KM) with full coverage in freely convertible foreign exchange (fx) reserves and a fixed exchange rate of 1KM: 0.51129 EUR. The CBBH is obliged under its charter to ensure that the aggregate amount of its monetary liabilities shall at no time exceed the equivalent of its net fx reserves (Art.31).[9]

The CBBH operates a strict currency board with no authority to carry out discretionary monetary policy. The currency board appears to enjoy confidence of the general public and provide stability amid a difficult institutional environment of the country. The CBBH cannot engage in money market operations (Art.37), extend loans to commercial banks or issue securities; thus it cannot assume any Lender of Last Resort (LOLR) functions. Reserve requirements are the only monetary policy instrument at the disposal of the CBBH. In addition, the CBBH has a coordination role as regards financial stability in view of two separate banking supervisors in Bosnia and Herzegovina's constituent entities (i.e. Republika Srpska and the Federation of Bosnia and Herzegovina), but no formal supervisory responsibility.[10]

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

The pace of economic activity gathered momentum in 2015, driven by domestic demand and net exports. Real GDP expanded by 3.2% in 2015 according to IMF estimates (Spring 2016 WEO), with authorities estimating a less robust outcome (2.5%) in their ERP document. This constituted an increase in the pace of economic activity relative to the 1.1% expansion in real GDP posted in 2014 (see Chart 1). Domestic demand remained dynamic, though consumption exceeded 100% of GDP and thus underscores the need to rebalance the drivers of growth towards production of goods and services going forward. Net exports also contributed positively to growth, contrary to what was the case in 2014, with industrial activity gathering momentum especially in the areas that were most affected by the severe floods in 2014 (for example mining and food products).

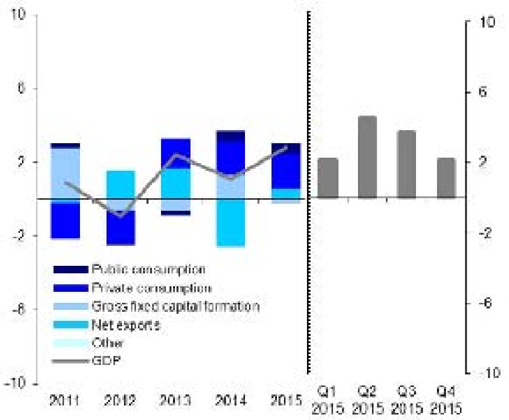
Growth is projected to accelerate further in a medium-term context, with strong domestic demand still seen as the main driver of real activity. The baseline detailed in the ERP – with real GDP expanding by 3.0% and 3.2% in 2016 and 2017 respectively – is broadly in line with forecasts by external

[9] Monetary liabilities refer to currency in circulation, domestic deposits by banks and other residents whereas net foreign exchange reserves represent gross foreign exchange reserves (currency notes and deposits in foreign currency, foreign securities and gold) minus foreign liabilities of the CBBH.

[10] The supervisory tasks over the branches established in the Brcko District are conducted by the respective entity-level supervisor depending on the location of the headquarter of the commercial bank in question.

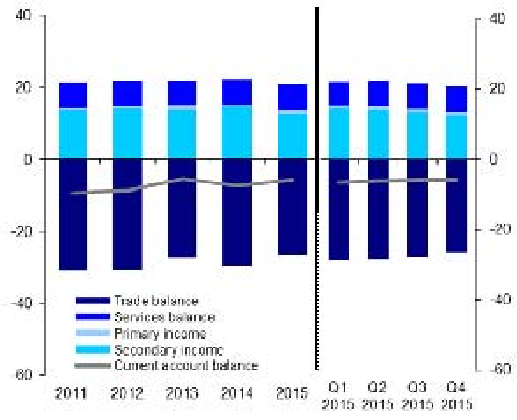
stakeholders.[11] Private consumption is foreseen to pick up only at a moderate pace, reflecting stubbornly high levels of unemployment going forward in spite of the recent adoption of new labour laws in both entities. It is thus foreseen that investment, which is projected to expand by 9% per annum on average over 2016-2018, would be the driver of domestic demand and (hence) growth in the period ahead, along with an expansion of exports.

Chart 1. Contributions to real GDP growth
(annual percentage change in real GDP)



Notes: Annual data from WEO (April 2016 update), quarterly data are from national sources. Quarterly data are computed as annual growth with respect to the same quarter a year earlier.
Sources: Agency of Statistics of Bosnia and Herzegovina, Haver Analytics, IMF/WEO and ECB staff calculations.

Chart 2. Components of current account balance
(in % of GDP)



Note: Quarterly data in are computed as a moving sum of the last four quarters.
Sources: CBBH, Agency of Statistics of Bosnia and Herzegovina, Haver Analytics and ECB staff calculations.

Risks to the outlook appear tilted towards the downside on account of both external and domestic factors. On the external front, the possibility of a more protracted recovery in the country's main trading partners than currently anticipated might dampen foreign investment. On the domestic front, authorities seem to be counting on increased contributions from both domestic savings and non-budgetary financing (mostly in the form of grants and loans from international donors) to fund the investment drive going forward. However, increased investment appears to be partly contingent on an improvement in the 'doing business' and broader institutional climate, which would in turn demand policy action and structural reform on the part of authorities for a sustained period of time. The possibility that on-going negotiations for a new Fund-supported programme do not come to a successful conclusion (or are more protracted than currently envisaged) constitutes a further downside risk to the outlook.

External imbalances narrowed in 2015 but are projected to widen going forward. The trade deficit narrowed to 24% of GDP in 2015 from 27% of GDP a year earlier, largely on account of improved external demand from key trading partners (on the export side) and lower oil prices (on the import side). Higher surpluses on the service and primary income accounts also contributed to this outcome. The ERP

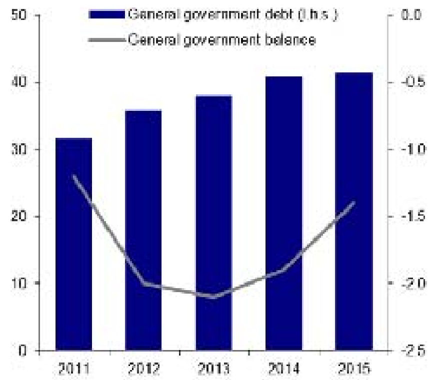
[11] The IMF (October 2015) forecasts a real GDP growth of 3.0% in 2016, the same as the EBRD, with the World Bank forecast tilted to the downside (2.3%).

document baseline foresees an expansion of imports with annual growth rising to 5.2% in 2018 from 1.5% in 2015, largely driven by domestic demand and rising employment and wages. Coupled with the expected fall in current transfers, which are foreseen to decline by 6.6% on average per annum over the 2016-2018 period, this is anticipated to lead to a widening of the current account deficit to 7.6%, 8.2% and 9.0% of GDP in 2016, 2017 and 2018, respectively (see Chart 2). As also acknowledged in the ERP document, risks to the baseline for external balances appear tilted towards the downside, particularly in the event of a slower recovery than currently anticipated in main trading partners.

Net FDI flows have thus far disappointed, but are seen by authorities to be more dynamic going forward so as to keep external imbalances in check. Net FDI inflows averaged just 1.6% of GDP in the year to 2015Q3, covering just a quarter of the current account deficit. FDI flows continue to remain narrowly focused in energy and infrastructure projects, in turn dampening the effort to broaden the production base. Looking ahead, authorities anticipate a more sanguine outlook for FDI, rising to 3.0% of GDP in 2018 from 2.5% of GDP in 2015, including as a result of several planned privatization projects. However, the prospect for FDI inflows remains sensitive to risks in the external environment, which in turn might imply a downside risk to the financing of external imbalances.

The fiscal performance improved in 2015 and further consolidation is foreseen in the period ahead. The fiscal deficit is estimated by authorities to have edged down to 1.4% of GDP in 2015, from 1.9% of GDP in 2014 (see Chart 3). Higher revenues, in particular from indirect taxes (including excise duties) that tend to account for nearly half of total revenues, contributed to this outcome. Going forward, authorities forecast a further narrowing of the fiscal deficit to 1.2% and 0.1% of GDP in 2016 and 2017, respectively, turning into a fiscal surplus of 1.1% of GDP in 2018. Authorities' efforts to establish non-independent fiscal councils (or similar fiscal governmental coordination bodies) at both state and entity level are a welcome development. However, the checks and balances inherent in the system appear to be weak, both across the coordination mechanism for the country as a whole and within the functioning of the councils themselves (especially in the Federation).[12] This suggests that the mechanisms to control spending *ex ante* or hold authorities accountable (at various levels of government) for meeting the fiscal targets which they have set *ex post* do not seem to be fully in place.

Chart 3. Government gross debt and balance
(in % of GDP)



Note: 2016 ERP expected figures for 2015.
Sources: European Commission, Ministries of Finance of Federation of Bosnia and Herzegovina and Republika Srpska, Directorate of Economic Planning of Bosnia and Herzegovina and ECB staff calculations.

In the absence of a Fund-supported programme authorities resorted to increased debt issuance in domestic markets to help bridge the financing shortfall. This development was particularly visible in

[12] Yet, authorities are strongly committed to deal with the accumulated deficit of the Federation's cantons within a 5-year period as a means to avoid further build-up of public arrears.

the Federation, where financing from domestic sources grew in 2015 by 15% as compared to 2014, as well as in the country's other entity (Republika Srpska), although in the latter case not all intended debt placements could be successfully allotted at some primary auctions. In spite of this, around two-thirds of outstanding debt for Bosnia and Herzegovina as a whole remains external in nature, mainly from multilateral creditors, as the country has not been able to access international capital markets. With gross financing needs remaining elevated going forward (7.1% and 7.5% of GDP in 2016 and 2017 respectively, according to IMF estimates) and some banks' appetite for entity-level paper seemingly tempering, the medium-term viability of this strategy remains questionable. As a result, protracted delays in the availability of multilateral funding for Bosnia and Herzegovina appear as a key downside risk for the sustainability of public finances. Overall, the ERP document anticipates the general government debt to slightly increase to 41.7% of GDP in 2016 (from 41.3% of GDP in 2015), before gradually falling to 33% of GDP in 2018.

2.2 Inflation, exchange rates, monetary policy and financial stability

Inflationary pressures remained subdued in 2015 largely on account of external factors. Annual inflation as measured by the CPI index averaged -1.0% for 2015 as a whole, with the downtrend driven by lower international prices for food and oil as well as some other items (such as clothing and footwear category) (see Chart 5). Looking ahead, the ERP document anticipates that inflation will increase to 1.0% in 2016, including as a result of higher excise duties, while no major changes in utility-related prices are expected. Currently the central bank has no tools to gauge expected price developments such as an inflation expectations survey.

Monetary policy has continued to be anchored around the currency board arrangement. The CBBH continued to ensure full convertibility of the domestic currency by backing net monetary liabilities with foreign exchange reserves. Both foreign exchange reserves and monetary liabilities increased in 2015 on account of the rise in commercial bank deposits. The currency board's coverage of monetary liabilities stands at comfortable levels, reaching 105.2% at end-2015, or around 7 months of imports and 30% of (2015 estimated) GDP, respectively. In May 2015, the CBBH amended the calculation of required reserves remuneration in order not to pass through entirely to banks the impact of negative interest rates it was receiving on managed foreign reserves.[13]

Lending dynamics have been weak as banks have continued to engage in balance sheet repair. Total loans to the private sector grew by 2% in 2015 as a whole on account of lending to the household and government segments, which account for 44% and 10% of total bank lending, respectively (see Chart 4). Although lending to corporates swung into to positive territory starting in November 2015 (on an annual basis), it remained subdued in the year as a whole as companies appear cautious to invest in view

[13] The banks' remuneration rate for required reserves is equal to the average EONIA rate reduced by 10 basis points. If this rate is negative, then the remuneration rate is equal to zero, i.e. a lower bound was introduced. In addition, the zero rate applies also to all banks' funds exceeding the reserve requirement.

of economic uncertainty.[14] The central bank currently has no tools to gauge both current and expected credit conditions such as a lending survey.

Chart 4. Money and credit growth
(annual percentage change)

Chart 5. Consumer price inflation
(annual percentage change)

Sources: CBBH, BiH Agency for Statistics, IFS, Haver Analytics and ECB calculations.

The banking system appears to remain resilient overall. Banks continue to exhibit robust capital and liquidity buffers. The regulatory capital adequacy ratio declined slightly to 16.3% in 2015Q3 from 16.2% in 2014Q4, but still remained well above the regulatory minimum of 12%. The ratio of liquid assets to total assets and short-term liabilities stood at 25.8% and 43.4% in 2015Q3, respectively. Bank profitability has also improved in 2015, with average return-on-equity and return-on-asset ratios amounting to 7.6% and 1.0% in 2015Q3 respectively, as compared with 5.2% and 0.7% in 2014Q4.[15] Solid deposit growth amid weak credit demand has also contributed to a sizable reduction of risks to the bank funding base, with the loan-to-deposit ratio for the system as a whole declining to 103% in end-2015, from 119% in end-2012.

However, pockets of vulnerability remain in the banking system and challenges to asset quality continue to be unaddressed. First, a few domestically-owned banks appears vulnerable. While these tend to be small players in the market, their difficulties contribute to increased banking uncertainty and also pose risks to the public balance sheet to the extent that they will require support from fiscal authorities. Supervisory authorities are cognisant of the risks involved and are working towards a solution for the banks involved. In this context, it is important that the new banking laws, which are planned for the entity-level supervisors, equip them with tools consistent with state-of-the art banking supervision. The planned upgrade of the resolution framework will also be an important ingredient to increase the resilience of the system, although it has yet to be decided whether resolution tasks will be conferred upon the state- or entity-level. The planned asset quality review of some banks should help to shed light on the

[14] See: Deloitte's "Central Europe CFO Survey 2016 – Bosnia and Herzegovina", 2016 http://www2.deloitte.com/content/dam/Deloitte/ba/Documents/about-deloitte/ba_CFO2016_2016_BiH_final.pdf

[15] Profitability appears to have been influenced by the application of new accounting rules by banks which led to a decrease in the non-interest expenses by banks, as well as by lower provisions for impaired loans.

remaining pockets of vulnerability in the system. It will be important that authorities quickly follow-up on the potential outcomes of this exercise. Second, challenges to bank asset quality remain unaddressed. The quality of bank's loan portfolios has somewhat improved with the share of non-performing in total loans and the share of non-performing loans net of provisions to capital decreasing to 13.8% and 26.2% in 2015Q3 as compared to 14.2% and 27.9% in 2014Q4, respectively. Notwithstanding this improvement, large increases in NPLs seemed to be clustered around domestically-owned banks whose risk management practices and wider business models appear to be weak. Banks still report a number of difficulties in terms of NPL resolution, including the possibility for creditors and debtors to negotiate out-of-court restructurings, the transferring of liabilities to specialised companies (i.e. asset management companies), the possibility to sell certain types of loans or the tax treatment of such sales. While some of these shortcomings might be dealt with by the new bankruptcy law, weaknesses in legal and judicial frameworks which are also standing in the way of NPL disposal would persist. Taken together, this suggests that fostering NPL resolution should remain a priority for domestic authorities. Currently there is no comprehensive strategy to deal with NPLs involving all key stakeholders in the system in place (as has been done in some peer countries). Furthermore, medium-term risks might also emerge from a restructuring of the parent banks of some subsidiaries.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

The 2015 ECOFIN Council conclusions identified a number of areas in need of further policy action by authorities in Bosnia and Herzegovina, such as (i) improving the budget management framework, (ii) reduce labour market rigidities and (iii) address the issue of NPLs, especially in the context of impediments related to judicial enforcement. Compliance by authorities with the targeted policy guidance has been varying. On the fiscal front, authorities undertook efforts to ensure a timely adoption of the 2016 budgets. In addition, fiscal councils at the entity level were established, although their control and enforcement capability to ensure agreed fiscal outcomes does not seem adequate as yet. Concerning labour markets, authorities in each entity adopted new labour laws. In the area of NPLs resolution authorities are still in the process of drafting new bankruptcy laws that should remove some (but not all) of the obstacles which banks face to dispose of bad loans.

3. Assessment

Economic activity picked up in 2015 and is projected to further accelerate in the period ahead. However, the outlook is subject to a number of downside risks on account of both external and domestic factors. Structural and institutional difficulties in the economy continue to significantly weigh down on growth, while the fiscal room for manoeuvre is rapidly declining. Looking forward, further progress in structural reforms (including as regards privatisation, labour markets and administration), improvements in the overall business environment and the harmonisation of the regulatory environment across entities should help to lift growth potential, *inter alia* through higher foreign and domestic investment. The limited degree of policy freedom available to the central bank will continue to imply that the main tools for authorities to affect economic activity will primarily be fiscal and structural policies. Against this background, the following aspects should be highlighted:

While the currency board arrangement has continued to provide a stable anchor in a challenging external and domestic environment, an upgrade in the central bank's tools to gauge price and lending developments would be welcome. The currency board has continued to secure the full convertibility of the domestic currency and appears to enjoy a high level of credibility with the general public at large and support of domestic authorities. As such, this arrangement continues to be a cornerstone of macroeconomic stability amid a complex domestic institutional environment. Within the limited tools at its disposal, the development of inflation expectations and lending surveys by the central bank would be helpful to better gauge underlying price and credit developments.

Fiscal performance has improved, but the sustainability of public finances in the absence of multilateral funding remains questionable. The budget deficit narrowed in 2015 and authorities have set a further consolidation path for the years ahead. However, authorities' strategy of resorting to the issuance of domestic debt securities (which are purchased by local banks) to fund entity-level deficits seems untenable relative to their ability to generate revenues and in a context of low domestic savings. Downside risks to the public finances in the event that a new programme is not agreed with the IMF are thus significant.

An enforceable rules-based framework to instil discipline at all levels of government should be developed in order to credibly anchor fiscal policy in a medium-term context. The establishment of non-independent fiscal councils at both state- and entity-level is a welcome development provided that they improve the coordination of fiscal outcomes. However, these bodies do not seem to be equipped with sufficient tools to ensure that discipline is maintained at all levels of government and that (if that is not the case) corrective action is taken. Fiscal targets would then remain based on political commitments of different authorities, and contingent liabilities for the public balance sheet stemming from state-owned enterprises and extra-budgetary commitments might be difficult to contain. The establishment of greater checks and balances across state- and entity-level councils to foster fiscal compliance, as well as of a truly independent (non-governmental) fiscal council which would monitor progress on this front, would thus be welcome in order to credibly anchor fiscal policy in a medium-term context.

The banking sector remains sound overall, though pockets of vulnerability remain, and the legal infrastructure relevant to the financial system should be upgraded. The banking system as a whole continues to post robust capital and liquidity buffers, profitability is improving and funding risks have tempered. However, some small domestic banks have been a source of financial instability, implying that a plan to deal with shortcomings which might be revealed by the forthcoming asset quality review on such entities should be developed. Authorities have also embarked on a set of legislative reforms which would buttress the legal underpinnings of the financial system. Key elements in this regard include a new bankruptcy law, a new banking law, and the establishment of a resolution framework, and it will be important to secure timely parliamentary approval of such legislation. Concerning resolution, it would seem appropriate from an efficiency point of view that a centralised resolution authority be established, consistent with the state-wide deposit guarantee scheme in place. If this were not to be the case, policy coordination among the two bodies entrusted with resolution (i.e. the entity-level supervisors) should be maximised. The authorities' intention to develop a macro-prudential framework would also be welcome so as to buttress the stability of the financial system.

A comprehensive strategy to deal with NPL resolution should be developed. Challenges to banks' asset quality remain sizeable in the form of high non-performing loan burdens. This entails both a threat to financial stability (through its impact on bank profitability) and an obstacle for financial intermediation (through its impact on credit extension). While the new banking laws might contain elements to facilitate the treatment of NPLs (such as out-of-court workouts or the sale of bad loans to specialised companies), other important issues related to NPL resolution, such as judicial enforcement or tax issues would fall outside its scope. In light of this, the establishment of a comprehensive NPL resolution strategy involving all key stakeholders and entailing clear deadlines for policy action would be welcome, following the example of some peer countries.

Kosovo

1. Monetary and exchange rate policy framework

In 2001, the United Nations administration in Kosovo[16] **(UNMIK) officially conferred the euro legal tender status in Kosovo**[17], following the adoption of an UNMIK regulation in September 1999[18] which allowed the use of currencies other than the Yugoslav dinar in Kosovo, with the deutsche mark to be used in budgets, financial records and accounts as well as for compulsory payments and administrative fees. The 2002 euro cash-changeover was implemented in parallel to euro area member states.

In November 2000, the ECOFIN Council emphasised that any unilateral adoption of the single currency by means of "euroisation" would run counter to the underlying economic reasoning of EMU in the Treaty.[19] The Council declared in 2007 (with respect to Montenegro's) that the exceptional circumstances leading to its euro adoption were acknowledged, but recalled that unilateral euroisation was not compatible with the EU Treaty. However, the Council did not lay down a specific solution, stating that the implications of the Treaty framework for the country's monetary regime would need to be detailed by the time of possible future negotiations for accession to the EU at the latest.[20] In December 2003 the Governing Council of the ECB published a policy position on exchange rate issues relating to the acceding countries, reiterating the Council's view from the year 2000.[21] In 2012, the ECB's Governing Council recalled the 2007 Council declaration, implying that all options would remain on the table.

In the context of unilateral euroisation, the scope for discretionary monetary policy in Kosovo is very limited. Accordingly, the main objective of the Central Bank of the Republic of Kosovo (CBK) is to foster the soundness, solvency and efficient functioning of a stable market-based financial system and, without prejudice to this, support the general economic policies in Kosovo with a view to contributing to an efficient allocation of resources in accordance with the principles of an open market economy. The CBK acts as regulator and supervisor of the financial system. Within the powers provided by law, the CBK is independent in accomplishing its main objectives and exercising its duties. Its main monetary policy tool is minimum reserve requirements.

[16] This designation is without prejudice to positions on status, and is in line with UNSCR 1244 and the ICJ Opinion on the Kosovo Declaration of Independence.

[17] UNMIK administrative direction 2001/24 from 21 December 2001 amending UNMIK regulation 1999/4 (http://www.unmikonline.org/regulations/admdirect/2001/ADE%202001-24.pdf)

[18] UNMIK regulation 1999/4 from 2 September 1999 "On the currency permitted to be used in Kosovo" (http://www.unmikonline.org/regulations/1999/re99_04.pdf), implemented by UNMIK administrative direction 1999/2 from 4 October 1999 (http://www.unmikonline.org/regulations/admdirect/1999/089%20Final%20%20ADE%201999-02.htm)

[19] Report by the (ECOFIN) Council to the European Council in Nice on the exchange rate aspects of enlargement, 8 November 2000, Council of the European Union press release no. 13055/00.

[20] Council Decision on the signing on behalf of the European Community of a Stabilisation and Association Agreement with Montenegro, 9 October 2007, Council of the European Union press release No 13484/07.

[21] https://www.ecb.europa.eu/pub/pdf/other/policyaccexchangerateen.pdf

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

Kosovo experienced a pick-up in real GDP growth in 2015 after a weak economic performance in 2014. According to the estimates detailed in the 2016 ERP, real GDP growth amounted to 3.8% in 2015, (or 0.3pp lower than initially foreseen in the 2015 ERP), compared with 1.2% the previous year (also stemming from political turmoil after the June 2014 elections, see Chart 1). Indicators suggest that political instability weighed on growth as well in the second half of 2015, albeit to a lesser extent.[22]

Chart 1. Contributions to real GDP growth
(annual percentage change in real GDP)

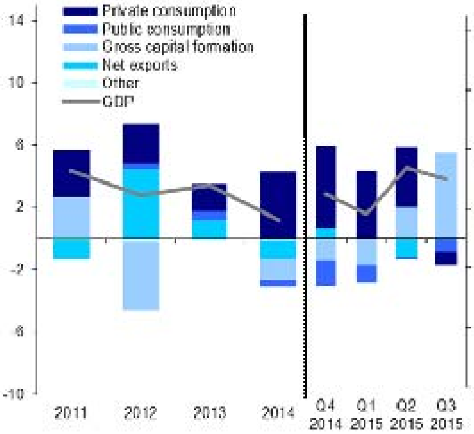
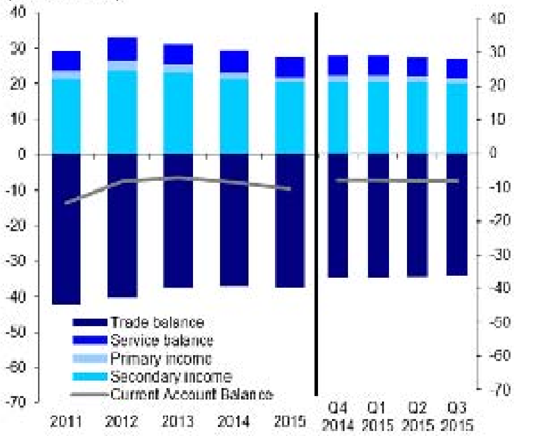


Chart 2. Components of the current account balance
(in % of GDP)



Notes: Quarterly figures for the current account balance are a moving sum of the most recent four quarters. In the case of contributions to real GDP growth, annual growth with respect to the same quarter a year earlier.
Sources: Central Bank of the Republic of Kosovo, Haver Analytics, IMF/WEO, Kosovo Agency of Statistics and ECB staff calculations.

Private consumption continued to be the main driver of growth in the first half of 2015, to a large extent fuelled by the strong inflow of remittances and the public sector wage increases implemented in 2014. A pick-up in investment as well as in FDI was also observed in the second half of 2015.

Economic activity is expected to accelerate further over the ERP horizon. Private consumption is anticipated to continue being an important driver of growth, supported by remittances (essentially from Germany and Switzerland), real growth in public sector wages (following continued low international food prices) and improved access to finance, with the latter expected to support consumer lending. Also private investment is anticipated to increase in the near-term following tax policy reforms[23], improved infrastructure, more business-friendly environment and decreasing lending costs.[24] The baseline detailed

[22] In spite of a strong pick-up in the first half of 2015, national authorities anticipate a downward revision of full-year 2015 growth figures compared with what was indicated in the ERP given the economic slow-down in the last quarter of the year.

[23] The 2016 ERP details a number of tax policy reforms undertaken in 2015, inter alia VAT exemptions for a number of sectors and a reduction in the threshold for VAT registration with the aim of allowing more businesses to reimburse VAT on their inputs.

[24] National authorities deem that lending costs will decrease following the implementation of planned reforms of the judiciary and property right systems, as well as through a credit guarantee scheme where SMEs lacking the appropriate collateral for borrowing can receive guarantees for up to 50% of the borrowed amount.

in the ERP (with real GDP growth seen at 4.0% in 2016 and 4.3% 2017-2018 respectively) is however slightly more optimistic than that of external stakeholders.[25]

Risks to the outlook appear tilted towards the downside on account of both external and domestic factors. On the external front, as also acknowledged in the ERP, a more subdued recovery in the international environment than currently foreseen might impinge on domestic growth prospects through lower remittances from the diaspora and lower global prices for metals (which accounted for almost half of Kosovo's exports in value terms in 2015). As regards domestic factors, the ERP singles out the fragile domestic energy production capacity as the principal downside risk to economic activity, where a drop in production would force the government to shift capital spending to subsidy spending. The possibility of political uncertainty dampening growth (including through lower investment and consumption) constitutes a further downside risk to the outlook.

External imbalances remained high in 2015, with the current account deficit widening to an estimated 9.6% of GDP, from 7.9% in 2014.[26] The deterioration of the current account, which was almost 3pp higher than that foreseen in the 2015 ERP, was attributable to lower primary and secondary income surpluses, but also to stubbornly high merchandise trade deficit of 37% of GDP (largely predetermined by exports concentrated in one sector, the high import component of domestic consumption as well as the low competitiveness in producing substitutes to imports). Looking ahead, the current account deficit is expected to remain high, averaging 9% of GDP over the ERP horizon, largely on the account of import concentration in both private consumption and public infrastructure projects. Remittances account for the largest share of the secondary income account and partly offset the high trade deficit (as shown in Chart 2). Authorities deem that remittances will maintain their share to GDP at an average of 14% over the ERP horizon. The high current account deficits foreseen for the period ahead are expected to be largely covered by strong FDI inflows reaching about 6% of GDP in 2015 (up from 2.7% of GDP in 2014 reflecting the sale of foreign companies to residents but also the impact of the domestic political turmoil). The ERP baseline anticipates robust FDI inflows in the near-term, to a large extent stemming from an improved external environment, a more business-friendly climate and several planned private investment projects (such as the construction of an energy power plant, scheduled to start in end-2016), in net terms amounting to about 5.6% of GDP on average 2016-2018. The signature of the Stabilisation and Association Agreement (SAA) with the EU in October 2015 could also contribute to this upward trend.

External competitiveness remains a matter of concern. The authorities' choice of monetary and exchange rate policy regime implies that improvements in competitiveness can only be achieved through productivity gains or through cost adjustments, a problem which is compounded by the narrow production base. The measures presented in the ERP aim at improving non-cost competitiveness by boosting domestic production through better access to finance (notably through enhanced judicial efficiency and

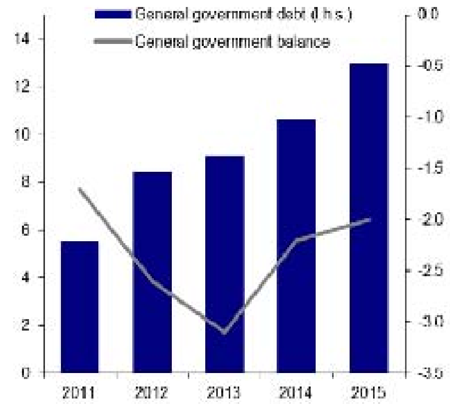
[25] IMF (October 2015) forecasts a real GDP growth of 3.8% in 2016, the World Bank 3.5% and the EBRD 3.0%, although IMF has signalled possible downward revision of the previsions in its next review due to delays in the Brezovica tourism investment project and the political uncertainty in the country.

[26] The current account balance for 2015 is divided by estimated nominal GDP from the IMF WEO (April 2016 revision).

property rights system, and consequently reduced costs of lending), the development of the export potential of new sectors, improved infrastructure and reduced informal sector. Price competitiveness (measured by real effective exchange rate) slightly improved in 2015. However, the drop in the World Bank's 2016 Doing Business ranking relative to 2015 (to 66th from 64th place, out of 189 countries) and the stagnating score in Transparency International's Corruption Perception Index (103 out of 167 countries in the 2015 vintage) suggest that much remains to be done for the business environment to positively contribute to economic activity and the growth potential.

Budgetary execution slightly improved with respect to both end-2014 outcomes and initially foreseen objectives for 2015. Authorities estimates that the overall general government deficit edged down to 2% of GDP in 2015, in line with the 2015 ERP estimates and 0.2pp less than the end-2014 deficit. The improvement was mainly attributable to increases in excise- and VAT rates amid stronger economic activity, which partially offset the burden on public accounts stemming from wage and pension hikes in 2014.[27] Some expenditure restraint on capital spending items, which amounted to 88% of its end-year plan, also contributed to this outcome. Public debt-to-GDP stood at 12.98% end-2015, up from 10.6% end-2014 (see Chart 3).

Chart 3. Government gross debt and balance
(in % of GDP)



Note: ERP expected figure for overall balance in 2015.
Source: Ministry of Finance of the Republic of Kosovo.

The fiscal deficit going forward is seen to be in line with the requirements of the fiscal rule, but implementation risks remain considerable. In the medium-term, authorities intend to reduce current spending in favour of higher (growth-enhancing) capital spending, in line with IMF recommendations under the stand-by arrangement. The amendment of the investment clause (part of the fiscal rule framework)[28] envisages additional investment projects for the period ahead. The 2016 budget foresees a further reduction of the overall deficit to 1.8% of GDP, benefitting from the tax measures taken in 2015 and the considerable slowdown in public sector wage increases.[29] The general government overall balance for 2017-2018 is anticipated to reach close to -1.9% of GDP per annum.[30] However, this would leave little room for authorities under the fiscal framework to accommodate unanticipated shocks were they to materialise or should real activity turn out to be less dynamic than currently expected.

[27] In 2015, the excise rates of tobacco and other products were increased, while a tax was also introduced for new items, such as natural gas and heavy oil. The standard VAT rate rose from 16% to 18%, and the threshold for VAT registration was lowered – with the aim of capturing businesses that previously were not eligible.

[28] The investment clause of the fiscal rule allows the government to finance additional growth enhancing projects through (debt) financing by IFIs and the projects are exempted from the fiscal rule ceiling. The clause was included in the law on public financial management and accountability in December 2015.

[29] The approved public wage rule will come into effect in 2018 and caps increases in the overall public sector wage bill at annual growth rate in nominal GDP. Until then, changes to the public sector wage bill will be limited by the IMF SBA fiscal targets.

[30] General government overall balance is expected to reach -1.6% in 2016 and -1.7% 2017-2018 if applying the fiscal rule definition, where spending from own source revenues carried forward and spending of the privatization agency are excluded.

Authorities plan to finance the foreseen government deficits mainly by resorting to domestic borrowing[31], including through the issuance of government bonds with longer maturities as was already the case in 2015 and early 2016.[32] The public debt-to-GDP level is expected to rise further to 20% of GDP in 2017 (or 5.5pp higher than the level foreseen in the 2015 ERP) and to 22% of GDP in 2018, respectively.

2.2 Inflation, banking sector and financial stability

Inflation remained in negative territory throughout 2015 on account of external factors. Average annual HICP amounted to -0.5% (see Chart 4) for the year as a whole amid lower commodities and food prices and low imported inflation from the euro area, although inflation turned slightly positive in January 2016 (increasing by 0.2% on a year earlier). The ERP sees annual inflation averaging 0.4% per annum in 2016-2017, and 0.6% in 2018. Consistent with both the nature of risks to economic activity as a whole and the imported character of inflation in Kosovo, risks to the authorities' inflation baseline appear tilted towards the downside. However, authorities perceive that domestic wage dynamics, the pick-up in lending and the strong inflow of remittances would help to put a floor to the decline annual inflation even in an adverse external scenario.

Chart 4. Consumer price inflation
(annual percentage change)

Chart 5. Private sector credit growth
(annual percentage change)

Notes: Private sector here comprises households and non-financial corporations.
Sources: Central Bank of the Republic of Kosovo, Haver Analytics, Kosovo Agency of Statistics and ECB staff calculations.

The banking sector appears to remain sound overall but financial intermediation continues to be low. The system exhibits robust capital and liquidity buffers with regulatory capital to risk-weighted assets standing at 19% and liquid assets to short-term liabilities at 44.9% in end-2015, respectively. Although foreign bank participation in the system is high (accounting for 90% of total banking assets), funding risks are low with banks mostly relying on domestic deposits for funding and loan to deposit ratios standing at 71% on average. Credit risks in the system also remain low by peer standards, with the ratio of NPLs to

[31] As Kosovo does not have a country credit rating, it does not have access to international capital markets.

[32] In 2015, there was a clear shift in government debt issuance in favour of longer maturities (with the first 3- and 5-year bonds). This is expected to continue in 2016 (another 5-year bond was issued in February) and the government is elaborating the issuance of a "diaspora bond", targeting remittances received from abroad as a way to finance investment projects.

total loans declining to 6.2% in 2015, while provisioning appears to remain adequate. Lending activity has gathered pace in 2015 amid a relaxation of credit standards, with total private sector credit edging up by 7.3% on a year earlier in December 2015 with both households and non-financial corporation lending proving to be dynamic. Lower interest rates on bank loans are also seen to have contributed to this outcome, with average weighted commercial bank lending interest rates falling to 7.7% in December 2015, as compared with 9.3% a year earlier.

However, lending rates are among the highest by peer standards and the spread over deposit rates also remains sizeable (see Chart 5). This partly reflects banks' high credit risk perception, which is in turn related to wide-ranging informality in the corporate sector and difficulties in the regulatory and the legal environment (inter alia related to contract enforcement, collateral execution, and property rights). Improvements in these areas would also help to buttress the overall NPL resolution framework. In addition, while remaining contained overall, the indirect exposure of the banking system to the sovereign through banks' holdings of domestic government securities has been rising significantly in recent years. Financial intermediation as proxied by the level of domestic credit to GDP remains low (about 36% in end-2015), including compared with peers. Coupled with the low loan-to-deposit ratios prevailing for the system as a whole, this suggests that plenty of scope for deeper financial intermediation remains to benefit the real economy.

In the absence of a traditional lender of last resort function by the central bank, the authorities have introduced an Emergency Liquidity Assistance fund. The fund was established by the CBK in September 2015. The intended overall volume of the fund is around 6% of total banking sector assets, with contributions from both the government and the central bank. Foreign-owned banks have been asked to provide "commitment letters" from parent institutions where pledges to provide liquidity assistance in case of need be. A similar procedure has been followed in the case of domestically-owned banks, which have been asked to secure a credit line with a foreign counterpart which could be activated should circumstances so warrant. Moreover, the central bank is in the process of developing a macro-prudential framework, as well as enhanced guidelines for on-site and risk-based supervision of banks, measures aiming at further strengthen the resilience of the financial system.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and prospective EU member countries

The 2015 ECOFIN Council conclusions identified a number of areas for further policy action by the authorities in Kosovo, including (i) sustaining the commitment to fiscal discipline (including the development of a legal framework to maintain a sustainable public wage bill); (ii) address the underlying causes for high costs of bank-based financing, reduce the duration and cost of insolvency procedures by adopting the new bankruptcy law and further improve contract enforcement with a view to increase overall financial intermediation in the economy; (iii) improve the business environment, including in a number of areas important for the financial sector (in particular judiciary effectiveness, property rights and the size of the informal sector); and (iv) develop measures to provide targeted support for SMEs and to widen their access to finance. Compliance by authorities with this targeted policy guidance has been varying. The public sector wage rule was adopted in 2015 and links wage increases to annual nominal GDP growth. A draft law on bankruptcy is currently being discussed in Parliament. The credit guarantee fund was adopted in late 2015 and targets domestic MSMEs having difficulties to borrow due to collateral constraints. Beyond these measures, the ERP details planned reforms in 2016 to increase judicial efficiency and to strengthen property rights through different channels.

3. Assessment

Kosovo's monetary and exchange rate policy regime continues to imply that authorities' degree of policy freedom remains constrained, thus putting a high burden on sound fiscal and structural policies. In this context, further progress needs to be made in order to increase the competitiveness of the economy, reduce external imbalances and diversify the drivers of growth, all of which should be conducive to a sustainable growth path in a convergence context. As also acknowledged in the ERP, key elements to spur domestic production and foreign investment, inter alia into tradable sectors, and shift away from an excessive reliance on private consumption for growth include improved judiciary efficiency, stepped up actions against corruption and informality.

While budgetary execution has been positive, the credibility of public finances under the rules-based framework has yet to be cemented. Fiscal performance in 2015 was in line with the rule-based fiscal framework, partially due to lower capital expenditures. However, the 2014 public sector wage hike prior to the elections damaged the credibility (and sustainability) of public finances. If respected, the public sector wage rule would however put a limit to further discretionary wage rises. A clear enforcement framework, in particular as regards corrective measures in case of fiscal slippages, would thus help to reduce incentives for discretionary policy actions by authorities and thereby contribute to the medium-term anchoring of fiscal policy. In addition, it is worth highlighting that the 2% of GDP fiscal deficit threshold should not be considered as an operational target but rather a maximum ceiling. More cautious medium-term budgetary planning would thus provide authorities with some room to accommodate adverse shocks to the economic growth which might materialise in the period ahead. Public debt-to-GDP (although still at low levels) seems to be on an upward trend and needs to be monitored carefully.

Within the limited policy room for manoeuvre at its disposal, the central bank's efforts to strengthen its monitoring and analytical toolkit are welcome, consistent with the aim of increasing the economy's resilience as a whole. Thus far, this has included the set-up of an alternative framework to a lender-of-last-resort function, the development of a macro-prudential framework, and enhanced guidelines for on-site and risk-based supervision of banks, respectively. Going forward, the establishment of a reliable measure of private sector inflation expectations would also help the central bank in its assessment of price developments.

Financial intermediation is still being dampened by legal and institutional factors. In spite of a recent relaxation in both lending standards and lending rates, financial intermediation is still being held back by a host of legal and institutional factors. Further progress in strengthening judicial efficiency and independence, collateral execution and the property rights system would thus help to reduce the risk priced in by banks as part of their normal lending activities, which should in turn ease constraints on access to finance for corporates. Other initiatives recently undertaken or under consideration could also support financial intermediation, such as the new credit guarantee scheme, and the issuance of longer-dated securities and "diaspora bonds" by the government (which could help to develop local capital markets, and channel remittances into growth-enhancing sectors).

The former Yugoslav Republic of Macedonia

1. Monetary and exchange rate policy framework

The maintenance of price stability is the primary objective of the National Bank of the Republic of Macedonia (NBRM). In order to preserve price stability the NBRM uses the level of the exchange rate as an intermediate target of monetary policy. The NBRM has anchored its exchange rate through a *de facto* fixed exchange rate to the euro. The IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) reports that the de jure exchange rate arrangement for the former Yugoslav Republic of Macedonia is floating, although de facto this is classified as a 'stabilised arrangement' on account of the fact that the NBRM intervenes in the foreign exchange market in order to maintain a stable exchange rate. The conduct of a fixed exchange rate policy regime is motivated by a high degree of economic openness and close trade links with the euro area and EU amid significant unofficial asset and liability euroisation in the economy.

The NBRM uses various types of instruments for monetary policy implementation, including open market operations, reserve requirements, deposit and marginal lending facilities and intraday credit. The main tool in this context is the auction of central bank bills (mostly weekly with a 28-day maturity) whose interest rate serves as the NBRM's key policy interest rate.

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

The economic recovery continued in 2015, with real GDP expanding by 3.7%. Economic growth became more balanced, with both domestic demand and net exports contributing to growth (see Chart 1). Consumption gathered pace in 2015, rising by 3.2% in the year as a whole, fuelled by growing employment, rising real wages and accelerating bank lending. Export growth, despite some moderation, remained robust on the back of new production facilities in the free economic zones. Coupled with a slowdown in import growth, it resulted in a positive contribution to GDP growth from net exports. After a strong performance in the 2014 and in spite of on-going public investment in infrastructure, investment growth remained weak[33].

The authorities expect a further acceleration in economic activity in the period ahead, with real GDP forecasts slightly more sanguine than those of external stakeholders[34]. The baseline depicted in the ERP projects a real GDP expansion of 4.0% and 4.3% in 2016 and 2017 respectively, with the output gap seen to be positive as of 2017. The continued economic recovery is anticipated to be driven by investment growth (7.5% in 2016 and 8.0% in 2017 and 2018), in particular through public investment and FDI. Private consumption is also expected to grow further (2.8% in 2016 and 3.4-3.5% in 2017-2018)

[33] Data on construction growth, imports of capital goods and FDI inflows suggest, however, that weak investment growth could be attributed to a fall in inventories.

[34] The NBRM forecasts GDP growth of 3.5% and 4.0% for 2016 and 2017 respectively, as compared to the IMF (3.2% and 3.3%), World Bank (3.4% and 3.7%), European Commission (3.5% and 3.5%).

fuelled by improving labour market dynamics. The contribution of net exports to growth is expected to be negative as imports are likely to surge on the back of high import content of investment. Risks to this favourable outlook appear tilted towards the downside on account of both external and domestic factors. On the external front, this includes the possibility that the recovery in the euro area turns out to be more sluggish than currently anticipated. On the domestic side, downside risks include a slower progress than currently anticipated to implement public investment projects as well as more subdued foreign investment should political instability continue in the future.

Chart 1. Contributions to real GDP growth
(annual percentage change in real GDP)

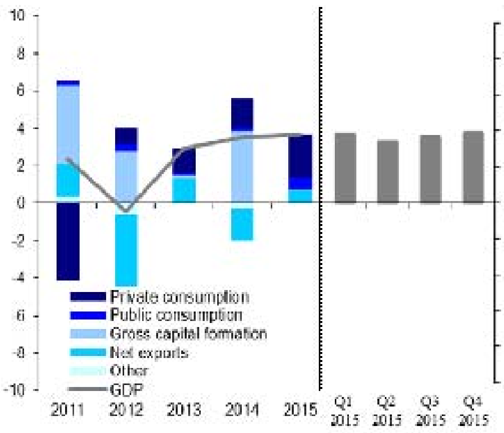
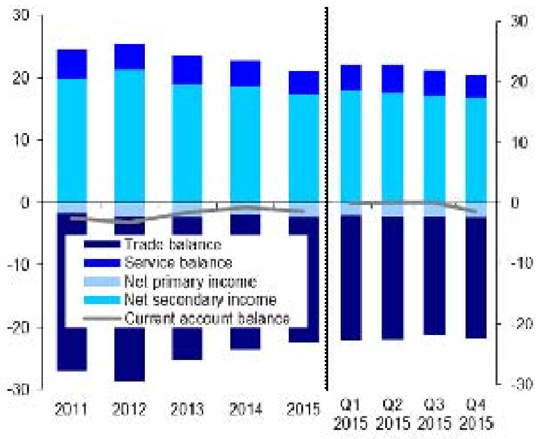


Chart 2. Components of current account balance
(in % of GDP)



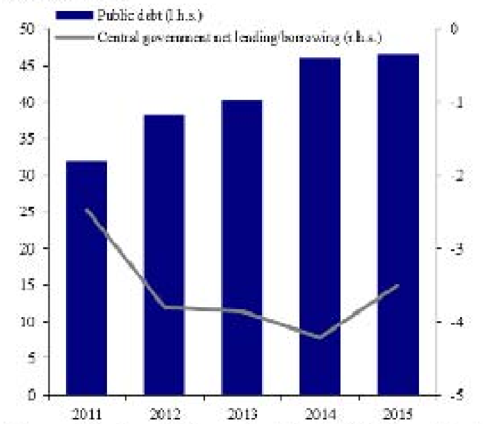
Notes: Quarterly GDP data are computed as annual growth with respect to the same quarter a year earlier. Quarterly data in Chart 2 are computed as a moving sum of the last four quarters.
Sources: National Statistical Office, National Bank of the Republic of Macedonia, ECB staff calculations.

Fiscal policy execution slipped again in spite of exceptionally high growth in revenues amid strong economic growth. The budget deficit amounted to 3.5% of GDP for 2015 as a whole (see Chart 3). Although this constituted an improvement relative to the 2014 outcome (of 4.2% of GDP), it still exceeded the original fiscal deficit target foreseen in the 2015 ERP by 0.2pp. This slippage took place in spite of a 10.5% annual increase in revenues, driven mostly by higher profit tax revenues and, to a lesser degree, by higher excise tax revenues as well. Looking at the expenditure side, high growth in spending on social transfers, goods and services as well as wages and allowances resulted in the highest annual increase in government spending since 2008 (amounting to 7.5% in nominal terms). Capital expenditures amounted to only 10.3% of all expenditures.

The authorities expect a further narrowing of the budget deficit in the period ahead, but this seems to be heavily predicated on the realisation of the robust macroeconomic outlook projected. The 2016 ERP foresees a narrowing of the fiscal deficit to 3.2% of GDP and 2.9% of GDP in 2016 and 2017, respectively. This means that the pace of planned fiscal consolidation presented in the 2015 ERP has been maintained in spite of the slower than expected progress in reducing the budget deficit in both 2014 and 2015. Fiscal consolidation efforts going forward appear to be focused mostly on the side of expenditures, with spending on collective consumption, compensation of public sector employees and social transfers being cut (in terms of their share in GDP). However, past experience suggests that keeping a lid on such budgetary items may be difficult to accomplish in practice. Moreover, the projected decrease in the headline deficit to below 3% of GDP by 2017 is seen to take place amid robust and accelerating GDP growth, while the estimated cyclically-adjusted deficit is seen to remain broadly unchanged (at 3.1% or 3.2% of GDP) over the projection horizon. This suggests that the sensitivity of fiscal balances to potential deviations from the authorities' bullish macroeconomic scenario remains high. In addition, higher than currently foreseen costs related to 'transit' migration flows might also impinge on the fiscal outlook to the extent that these are not fully reimbursed by international or regional external stakeholders. Overall, a tighter, countercyclical fiscal stance would help to ensure that the budget deficit path envisaged in the ERP is actually met.

Total public indebtedness edged up slightly, with the public debt to GDP ratio (including government guarantees) reaching 46.5% in 2015 as compared to 46% of GDP in 2014. The outstanding stock of public debt remained broadly unchanged relative to economic size once government guarantees are excluded (38.0% of GDP in 2015, as compared with 38.2% of GDP in 2014). Notwithstanding its recent decrease stemming from the repayment of obligations due to the IMF, the share of external debt in total public debt remains elevated (more than 60%), thereby rendering public finances vulnerable to external shocks or sudden shifts in investor sentiment. The ERP anticipates that total public debt (including guaranteed debt) will continue its gradual but steady uptrend in the period ahead, edging up to 52.4% of GDP in 2018. The fact that public debt dynamics are not seen to stabilise in spite of the robust growth outlook anticipated by authorities is a cause for concern.

Chart 3. Public debt and central government deficit
(in % of GDP)



Source: Ministry of Finance (public debt), National Bank of the Republic of Macedonia and ECB staff calculations (deficit).

The current account deficit increased in 2015 and external balances are projected to deteriorate going forward. The current account deficit increased to -1.3% of GDP in 2015, following -0.8% of GDP in 2014, despite a moderation in imports on the back of lower oil prices (see Chart 2). Despite some improvement, the trade deficit remained very high (16.5% of GDP in 2015 following 17.5% of GDP in 2014) and continued to be offset to a large extent by strong, if slowly decreasing, secondary income flows (17.7% of GDP in 2015 following 18.6% of GDP in 2014). Looking ahead, the ERP baseline anticipates a mild deterioration in the trade deficit over 2016-17. Coupled with a further decrease in surplus in secondary income, this entails that the current account deficit is projected to widen going forward to 1.9% of GDP in 2016 and 2.4% of GDP in 2017-18. However, the deficit is foreseen to be covered mostly by FDI inflows which are forecasted to gradually rise from 2.6% of GDP in 2015 to 3.3% of GDP in 2018. Insofar as external competitiveness indicators for the economy as a whole do not give cause for concern, the downside risks to this baseline thus mostly relate to potential external or domestic factors which would lead to a less dynamic pace of foreign investment than currently anticipated.

The authorities' choice of monetary and exchange rate policy framework will continue to imply that an adequate level of fx reserves will need to be maintained in order to fend off external vulnerabilities. Although foreign reserves were somewhat lower in end-2015 relative to a year earlier[35] (see Chart 5), reserve adequacy indicators appear adequate (including a reserve-to-import ratio at around 4 months and a reserve to short-term external debt with residual maturity above 1).

2.2 *Inflation, monetary policy and financial stability*

Inflation remained subdued in 2015 and, while authorities foresee a pick-up in the period ahead, private sector expectations have yet to point to this outcome. Headline inflation as measured by the CPI index decreased by 0.3% in 2015 as a whole, as was also the case in 2014 (see Chart 4). The fall in consumer prices was mainly attributable to external factors, including the downtrend in international prices for oil and lower imported inflation from the euro area. Core inflation also remained low. Looking ahead, authorities expect a robust pick-up in inflation to 1.5% in 2016, which thereafter is projected to further edge up to 1.6% and 2.0% in 2017 and 2018, respectively. The anticipated increase in inflation would primarily stem from higher inflation abroad along with rising commodity prices recovery, and to a lesser extent from the recovery in domestic demand as well. However, inflation expectations by the private sector do not (yet) point to this expected outcome, with the NBRM survey released in January this year showing that most economic agents' expected inflation to remain close to zero one year ahead. Risks to the authorities' inflation outlook thus appear tilted towards the downside mostly on account of external factors.

The NBRM has maintained an accommodative monetary policy stance further relaxing de facto monetary conditions for banks. Although the key policy rate has remained unchanged at 3.25% since 2013, the central bank cut interest rates on its overnight and seven-day deposit facilities rates in March 2015 (by 25bps and 50bps respectively, both in March 2015; see Chart 6). As the NBRM maintained its policy of limited absorption of commercial banks' liquidity surpluses through its monthly open market operations, banks continued to rely on the central bank deposit facilities for liquidity management purposes. Higher liquidity by commercial banks has also been influenced by the way in which authorities have chosen to finance government deficits (see below). In this environment, interbank market interest rates have fallen. Another measure aimed at maintaining accommodative monetary conditions was the renewal of non-standard measures aiming to facilitate commercial banks' lending to net exporters and electricity producers[36].

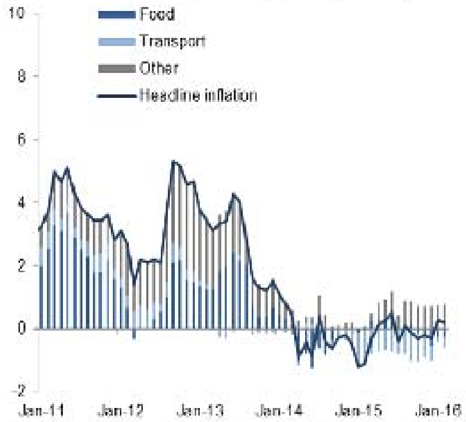
On the operational side, the NRBM continued to tightly manage the denar nominal exchange rate against the euro, but the impact of government transactions stemming from deficit financing is

[35] Decrease in fx reserves were due to transactions on behalf on the government related to interests payments on fx debt.

[36] Similarly to previous years the base for reserve requirements of commercial banks was reduced by the amount of new loans extended to the companies from these sectors.

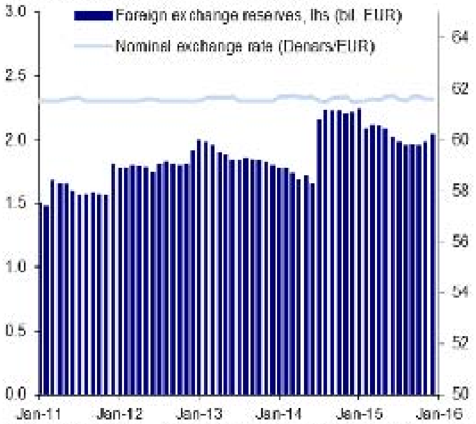
having a tangible effect on the size of its balance sheet. The scale of the interventions by the central bank was lower than in previous years, with the NBRM selling a moderate amount of fx on a net basis, mostly in 2015Q2. However, the central bank has been on the receiving side of authorities' growing recourse to external sources of funding for deficit financing, with its fx reserves levels largely shaped by the issuances of sovereign debt in international markets. This has thus led to an expansion of the central bank's balance sheet (which has doubled in nominal terms since 2005) and (relatedly) to a higher liquidity surplus in the banking sector as a whole, which the NBRM needs to sterilise. The central bank is also exposed to higher exchange rate risk (at least temporarily) than would otherwise be the case.

Chart 4. Consumer price inflation
(contribution to annual percentage change in CPI)



Sources: Haver Analytics, State Statistical Office of the Republic of Macedonia and ECB staff calculations.

Chart 5. Foreign exchange reserves and the Denar/Euro nominal exchange rate



Sources: Haver Analytics and National Bank of the Republic of Macedonia and ECB staff calculations.

Lending growth remained robust, with overall credit to the private sector rising by 9.5% in 2015 as a whole (see Chart 7). Lending to households was particularly dynamic, rising by 12.9% in 2015, with a strong contribution from consumption loans and mortgages. To limit the growth of consumption loans, the NBRM recently introduced (as of 2016) higher capital requirements for the loans with maturity longer than 8 years. Bank lending to the corporate sector expanded at a more moderate pace in comparison (7.1 % in 2015 as a whole), with reported difficulties in access to finance by small and medium enterprises weighing down on this market segment.

Spread compression between denar and euro interest rates applied by domestic banks contributed to further 'denarisation' of the economy, with most new credit being denar-denominated, and the share of deposits in local currency rising to 59.3% of the total in January 2016 (from 58.8% in January 2015). The continued application of differentiated reserve requirements for foreign and domestic currency by the NBRM[37] is seen to have contributed to this development.

[37] Since 2012 domestic currency liabilities with maturity over 2 years are subject to 0% reserve requirement. In August 2015 the NBRM extended zero rate reserve requirement for domestic currency liabilities over one year.

While the outlook going forward appears to be consistent with the gradual removal of monetary accommodation by the NBRM, room for further monetary policy easing should circumstances so warrant appears to be largely constrained by an expansive fiscal policy. With projected robust GDP growth, lending growth anticipated to remain dynamic, improving labour market conditions and an expansive fiscal policy, the central bank is likely to be more concerned about the pace of withdrawal of its accommodative policy stance rather than the reverse. However, should circumstances so warrant, for example in the event of a severe deterioration in the external environment which would in turn impinge on domestic growth prospects, room for further policy easing by the central bank consistent with the maintenance of the peg to the euro is likely to be limited barring a more restrictive fiscal stance.

The banking system appears to remain sound overall. Regulatory Tier I capital to risk weighted assets amounted to 13.9% in 2015Q4, increasing by 0.2pp relative to end-2014 and thus remaining at high levels. Banking sector liquidity also remained ample, and the profitability ratios have been improving in recent quarters (with return-on-equity amounting to 11.5% in 2015Q4, as compared with 7.4% in 2014Q4). Funding risks to the banking system also remain low, with banks mostly relying on domestic (admittedly short-term) deposits, loan to deposit ratios at 92.2% (in 2015Q4) and parent banks only accounting for 2.4% of total bank liabilities (in 2015Q3). Spillovers from financial turmoil in Greece materialising through Greek-owned bank subsidiaries operating in the country (which together account for more than 20% of total banking system assets), were limited in 2015 amid capital control measures towards Greece (for both banks and corporates) undertaken by the NBRM[38].

Notwithstanding these positive traits, a number of challenges to financial stability remain. First, the burden of bad loans on banks' balance sheets remain sizeable, with the ratio of NPLs to total loans amounting to 10.8% 2015Q4, as compared to 11.3% at the end of 2014. NPL burdens have not been brought down in spite of GDP growth and the pick-up in lending in 2015. Although provisioning remains healthy for the system as a whole and NPL specific provisions cover NPLs to a large extent (86.7% in 2015Q4), NPL resolution should still be a priority for authorities on account of its potential implications for the effective functioning of the monetary policy transmission mechanism as well as its threat to financial stability (impinging on bank profitability). Authorities have taken some steps to foster NPL resolution in recent years. For example, the NBRM's regulations on credit risk management adopted in 2013 seem to have encouraged banks to restructure part of their loan portfolios. In December 2015 the NBRM adopted a decision obliging banks to write-offs of claims which are fully booked for more than two years, starting from mid-2016. However, banks seem determined to still devote resources to collect the written off claims. This implies that the problem of uncollected claims and restructuring of debtors will remain unaddressed by this measure, resulting in window-dressing for balance sheets unless deeper structural problems are solved. Until now, banks have seemed as largely reluctant to write-off claims also pointing to problems in the sale of foreclosed assets.

[38] These measures were adopted in June and they pertain to restriction of capital outflows from residents of FYR of Macedonia to Greek entities based on newly concluded capital transactions. Banks from FYR of Macedonia were required to withdraw all loans and deposits from Greek banks, regardless of the agreed maturity. All residents were also banned to invest in Greek securities. The measures were lifted in December 2015 as the situation in Greece had stabilised.

Second, there are latent indirect risks to banks stemming from the still high share of fx denominated loans in total loans (46.5% in 2015Q4), which could materialise through unhedged borrowers in the event of adverse exchange rate developments. Third, potential spillovers from troubled parent banking groups which are undergoing restructuring and which may adversely affect local subsidiaries in a medium-term context cannot be ruled out.

Chart 6. Interest rates
(percentages per annum; monthly averages)

Chart 7. Money and credit growth
(annual percentage change)

Notes: Key interest rate for FYR Macedonia refers to the 28-day weighted average interest rate on the Central Bank Bills auctions. Interest rate on denar (both with and without a currency clause) - and foreign currency denominated loans are weighted averages of interest rates applied by commercial banks on new loans and deposits. Private sector here covers households and other (private) non-financial corporations.
Sources: Haver Analytics, National Bank of the Republic of Macedonia and ECB staff calculations.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and prospective EU member countries

The 2015 ECOFIN Council conclusions identified a number of areas for further policy action by the authorities of the former Yugoslav Republic of Macedonia, including (i) adhering to the medium term fiscal targets, (ii) improving the composition of spending by prioritising investment projects and fiscal transparency and (iii) adopting measures to clean-up non-performing loan portfolios. Compliance with this targeted policy advice has been varying. On the fiscal front, the government deficit for 2015 was exceeded relative to the target envisaged in the ERP, although the objective to reach a deficit under 3% of GDP going forward remains unchanged. The planned introduction of constitutionally-binding deficit and debt targets as of 2017 has yet to take place. Capital expenditures growth has underperformed as compared with the objectives set out in the 2015 ERP, while spending on wages and social benefits has increased.

In terms of the clean-up of NPL portfolios in the banking sector, some progress has been made as regards loan restructuring though this was the result of a measure already introduced in 2013. The NBRM adopted a decision in December 2015 obliging banks to perform write-offs of all claims which are fully booked for more than two years (in which banks determined and fully covered the credit risk of non-collection), starting from mid-2016.

3. Assessment

The economic recovery continued in 2015 and the drivers of economic activity became more balanced, with both domestic demand and net exports contributing to the growth. The outlook remains positive though risks to the outlook appear tilted towards the downside on account of both domestic and external factors.

Monetary policy has remained accommodative amid subdued inflationary pressures, but a shift in the policy stance appears advisable to the extent that sanguine economic prospects are realised. The exchange rate-based monetary policy framework pursued by the central bank has continued to provide a stable nominal anchor, but inflation remained negative in 2015 largely on account of external factors. In this environment, the central bank maintained an accommodative monetary policy stance and further eased credit conditions for banks de facto. Lending growth by banks was robust, particularly among households, prompting the central bank to put macro-prudential measures in place to curb the growth in consumer loans. Going forward, the authorities' baseline scenario foresees economic activity continuing to accelerate, with a narrowing output gap in 2016 and a pick-up in inflation. There is thus a case for a gradual removal of monetary accommodation by the central bank to the extent that this sanguine scenario is realised. However, in contrast, room for further monetary policy easing by the central bank should circumstances so warrant appears to be constrained by an expansive fiscal policy. Without prejudice to this, a gradual normalisation of the monetary policy signal in which the key policy rate was responsible for the transmission of impulses to interbank markets (rather than this being also dependent on interest rates prevailing in central bank deposit facilities, as is currently the case) would be advisable.

Fiscal policy execution slipped again in 2015 in spite of strong revenue performance, with authorities exceeding the deficit target which they had set for themselves, while total public indebtedness remained on an upward trend and has yet to stabilise. While the fiscal consolidation path which would see the deficit edging down to below 3% in 2017 has been maintained, this seems to be heavily dependent on the full materialisation of the authorities' sanguine macroeconomic outlook. Even slight deviations from this baseline are likely to endanger the consecution of medium-term objectives in the fiscal realm.

A stronger countercyclical fiscal stance under a rules-based framework would ensure that medium-term objectives are met, while helping to build buffers against unanticipated shocks and limit spillovers for the conduct of monetary policy. In a context where the authorities expect the (negative) output gap to be closed in 2016, the case for fiscal policy to lean against the cycle in a stronger manner appears to be compelling. A rules-based framework for fiscal policy – whose adoption has thus far stalled in the parliamentary process – would also be helpful to provide a clear anchoring of the medium-term orientation of fiscal policy. Moreover, a countercyclical fiscal stance would also help to build policy buffers against unanticipated (negative) shocks going forward. This is important because, in a context, where monetary policy is largely geared towards external objectives (peg to the euro), fiscal policy is the main tool available to authorities to smoothen the business cycle.

External imbalances have increased and growth dynamics going forward are likely to put additional pressure on trade and current account deficits, implying that reserve buffers will need to remain adequate. External imbalances are projected to widen going forward on account of an accelerating pace of economic activity and (relatedly) higher import content of FDI and public infrastructure projects. Thus far, buoyant remittance inflows have helped to keep the large trade imbalance in check, but authorities project that the strength of this type of (secondary) income will mildly decline in the period ahead. As the full benefits of public infrastructure projects and FDI for the broader economy are only likely to be reaped in a medium- to long-term context, the pressure on external balances is likely to remain significant in the near-term. Rising external indebtedness by the government is contributing to this trend. Lingering external vulnerabilities will thus imply that an adequate level of reserve buffers consistent with the maintenance of the peg to the euro is maintained by the central bank.

The financial system remains sound overall, but challenges to bank asset quality continue to demand attention by authorities and a comprehensive strategy to deal with NPL resolution should be developed. Challenges to banks' asset quality – in the form of high non-performing loan burdens – continue to pose a threat to financial stability through their impact on bank profitability, notwithstanding ample loan provisioning. While a new measure to force write-offs for certain types of loans has been developed, banks appear likely to continue to devote resources to collect such claims, implying that both the problem of uncollected claims and that of restructuring of debtors will remain unaddressed by this measure. NPL resolution should thus remain a priority for the authorities' policy agenda for 2016. The development of a strategy to deal with NPLs by all concerned stakeholders (and not only the central bank) would be helpful to this end. Action on NPLs by authorities would also help to remove any potential bottlenecks on future credit extension. This would also help to increase the efficiency of the monetary policy transmission mechanism.

Progress made in recent years promoting the use of the local currency in the banking system should be cemented through the development of a concerted strategy, consistent with the aim to reduce tail risks to financial stability and provide greater degrees of freedom for the conduct of monetary policy. Recent trends as regards the weight of the local currency in the banking system have been favourable on the side of both bank assets and bank liabilities, in part due to regulatory measures taken by the central bank. The current environment characterised by reduced spreads between local and foreign-currency denominated assets and liabilities suggests that the timing might be ripe to 'lock in' the gains made in recent years and push further to promote the use of the denar in the financial system. This is because, in spite of the positive trend noted above, just under half of the total outstanding loan stock by banks remains denominated in foreign currency, thereby posing a sizeable vulnerability to the banking system in the event of currency depreciation. The development of a strategy involving all key stakeholders would thus be a helpful element to both reduce latent financial stability risks and afford greater degrees of freedom to the central bank for the conduct of monetary policy.

Montenegro

1. Monetary and exchange rate policy framework

Montenegro has been using the euro unilaterally since 2002, following the use of the Deutsche Mark as sole legal tender since November 2000.

The ECOFIN Council has adopted clear policy positions on unilateral euroisation. In November 2000, the Council emphasised that any unilateral adoption of the single currency by means of "euroisation" would run counter to the underlying economic reasoning of EMU in the Treaty. In 2007, the ECOFIN Council adopted a declaration that acknowledged the "exceptional circumstances" which had led to Montenegro's unilateral adoption of the euro, but recalled that this was not compatible with the spirit of the EU Treaty. Furthermore, it stated that "... the implications of the Treaty framework for Montenegro's monetary regime will be detailed in due course, at the latest by the time of possible future negotiations for accession to the EU". In December 2003 the Governing Council of the ECB published a policy position on exchange rate issues relating to the acceding countries, reiterating the ECOFIN Council's view of 2000. In 2012, the ECB's Governing Council recalled the 2007 ECOFIN Council declaration, indicating that all options would remain on the table. Like in previous year, the authorities do not make any reference to this issue in the ERP document for 2016.

In the context of unilateral euroisation, the scope for monetary policy in Montenegro is very limited. Accordingly, the main objective of the Central Bank of Montenegro (CBCG) is to foster and maintain financial system stability as well as to contribute to achieving and maintaining the stability of prices. The central bank acts as the government agent in issuing Treasury bills. It runs a payment system and oversees the implementation of a macro-prudential framework. The CBCG also manages the country's international reserves and advises the government on economic policies. Reserve requirements are the only monetary policy instrument at the disposal of the CBCG.

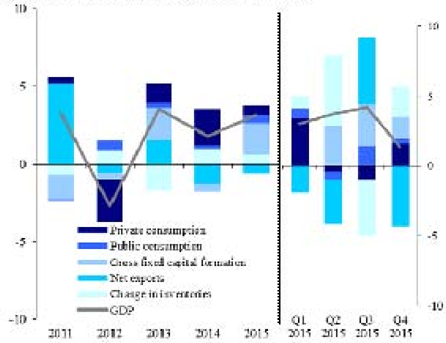
2. Economic and financial developments

2.1 Economic growth, the external sector and fiscal developments

Economic growth recovered in 2015, driven by public sector investment in infrastructure and robust tourism receipts. Real GDP expanded by 3.2% in 2015, up from 1.8% in 2014 (see Chart 1). Economic activity was fuelled by a strong rebound in public investment, which reflected preliminary works on the Bar-Boljare highway construction (henceforth 'the highway'). Consumption by households also increased moderately, supported by employment growth, thereby also contributing to the economic recovery. Additionally, increased tourism arrivals (partly reflecting rising instability in third countries) added to the growth in exports of services[39], however, due to increased imports related to the acceleration in investment contribution of net exports' to growth was negative

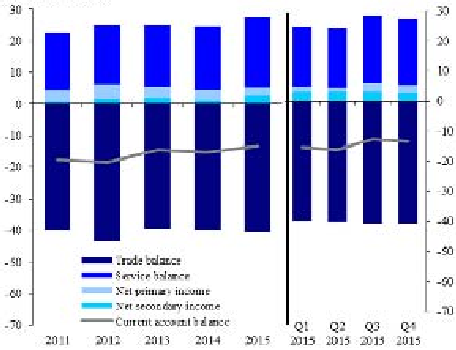
[39] Despite the rouble devaluation Russian tourist arrivals to Montenegro continued to increase and Russians continued to account for the highest number of overnight stays.

Chart 1. Contributions to real GDP growth
(annual percentage change in real GDP)



Sources: National authorities, Haver Analytics and ECB staff calculations.

Chart 2. Components of current account balance
(in % of GDP)



Note: Quarterly figures are a moving sum of the most recent four quarters.
Sources: Haver Analytics, national authorities and ECB staff calculations.

Government investment in public infrastructure projects is forecasted to remain the key driver of growth going forward. In line with the anticipated schedule for the construction of the highway, GDP growth is expected by authorities to remain close to 4.0% in 2016-2017 and to decrease to 3.0% in 2018. The authorities anticipate that spillovers from the highway construction will support private consumption, which, however, is foreseen to grow at an only moderate pace, with persistently high unemployment seen to be limiting wage growth.

However, the authorities' growth baseline is subject to a high degree of uncertainty, not only because it largely relies on a single construction project, but also due to the nature of the specific enterprise itself. Growth forecasts by external stakeholders also reflect this uncertainty through a high degree of dispersion[40]. Risks to the outlook thus appear tilted towards the downside on account of mostly domestic factors, including delays in the implementation of the highway project, as well as limited spillovers from the construction to other sectors of the economy due to supply-side bottlenecks[41]. On the external front, downside risks to the outlook include a more protracted recovery in the international environment than currently envisaged as well as uncertainty whether tourism inflows will be sustained given difficulties in origin countries (notably Russia).

The current account deficit narrowed in 2015, but external imbalances remain elevated and the economy continues to be highly vulnerable to external shocks. According to preliminary data the current account deficit narrowed to 13.4% of GDP in 2015, down from 15.2% in 2014, largely due to strong tourism receipts (see Chart 2). The trade deficit for goods, however, remained high in terms of GDP (40.7% of GDP in 2015 following 39.8% of GDP in 2014). As was the case in previous years, the

[40] The IMF forecast assumes GDP growth of 4.6% (in 2016), 2.5% (in 2017) and 2.5% (in 2018); the European Commission 4.0% (2016) and 4.1% (in 2017) and the World Bank 2.9% (in 2016), 3.0% (in 2017) and 2.9% (in 2018).

[41] Due to skill mismatches on the labour market and limited domestic production capacities, the highway is expected to be built mostly by Chinese companies, which would also bring with them the bulk of the labour force.

current account deficit was covered by robust FDI inflows related to equity investment in companies, banks and in real estate, as well as by portfolio inflows related to external borrowing by the government. Net errors and omissions persisted at high levels, which according to the authorities may be a symptom of the current account deficit being overestimated.[42]

Looking ahead, the ERP document foresees a widening of the current account deficit to 13.8% of GDP in 2016-2017, before narrowing to 12.2% of GDP in 2018, mainly attributable to import growth. FDI inflows are expected to remain robust, driven by investment in infrastructure, tourism, and the financial and real estate sector. Risks to this baseline appear tilted towards the downside on account of a mix of external and domestic factors, relating to higher than expected imports (the authorities expect a decrease in the share of imports in GDP, in spite of the high imports content associated to the highway project), less vigorous FDI inflows than currently foreseen, or weaker than expected tourism sector performance.

Competitiveness remains a matter of concern, as also suggested by the persistently high external imbalances. Goods exports performance has been weak in recent years when compared to regional peers and the share of low value added products in the total value of exports has increased. The real effective exchange rate appreciated in 2015 (mostly due to an appreciation against the Russian rouble), acting as a further drag on competitiveness. However, real wage growth remained broadly flat in 2015, which amid growing labour productivity contributed to a lowering of unit labour costs. The authorities' choice of monetary and exchange rate policy regime implies that competitiveness could only be improved by productivity gains or by a decline in wages and prices relative to key trading partners.

The fiscal stance was considerably loosened in 2015, with the budget deficit increasing to 8.0% of GDP in 2015, as compared to 3.1% of GDP in 2014 and the 6.5% deficit initially foreseen in the ERP document for 2015 (see Chart 3). Increased public spending in 2015 was accompanied by revenue underperformance which was particularly noticeable in the VAT, corporate tax and personal income tax components. This shortfall was not fully compensated by increases in health care contributions and the introduction of a special fee on oil to finance the highway project (which was ultimately repealed by the Constitutional Court, and as such will have a one-off effect on revenues).

Infrastructure projects will continue to put high pressure on public finances going forward, raising questions about the sustainability of public finances unless compensatory measures are taken. Authorities foresee the fiscal deficit to remain at just below 6% of GDP in both 2016 and 2017, largely on account of expenses related to the highway[43], before decreasing to 2.8% of GDP in 2018. With room for fiscal consolidation on the revenue side limited by the relatively high share of revenues in GDP (for an economy such as the Montenegrin one), the authorities foresee expenditures unrelated to the highway construction to fall in terms of GDP. Consolidation of government expenditures is intended to be focused mainly on public sector salaries and social transfers, however, in 2015 measures with the opposite effect were taken (such as the granting of life-long benefits for mothers with three or more

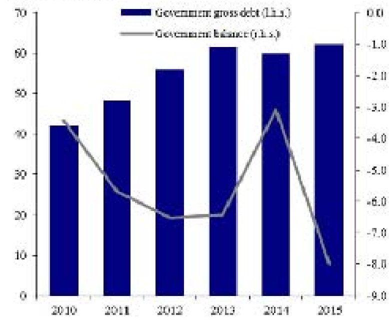
[42] The overestimation of the current account deficit may be a result of an underestimation of exports revenues (in the tourism sector) or an overestimation of imports (as part of the imports may be de facto FDI inflows).

[43] Which are estimated to reach in 2015-2018 in total approx. 22% of 2015 GDP.

children, or the envisaged hike in public sector wages and pensions) and there seem to be no concrete plans how to rein in consumptive public expenditure.

The authorities expect that public debt – which is estimated to have increased to 65.5% in 2015 from 59.9% of GDP in 2014 – will continue to trend-up and reach 78% of GDP in 2018. Moreover, it cannot be ruled out that the calling of government guarantees (which at the end of 2015Q3 amounted to 8.6% of GDP) exacerbates the already high public debt stock going forward.

Chart 3. Government gross debt and balance
(in % of GDP)



Sources: European Commission (debt), national authorities (deficit) and ECB staff calculations.

In a context of limited domestic savings, budget deficits are foreseen to be financed largely by foreign borrowing (including a US dollar-denominated loan for the highway construction)[44]. Reliance on external sources of finance will compound external vulnerabilities, especially as regards risks related to adverse exchange rate or interest rate shocks or shifts in investor sentiment. Overall, the sensitivity of public debt dynamics to growth and interest rate assumptions will remain high (as also acknowledged in the ERP, in which in the low-growth scenario public debt reaches 83% of GDP in 2018). Feedback loops between potential external and fiscal shocks and the real economy could be sizeable in an adverse scenario.

The credibility of the authorities' fiscal framework will be put to a further test in 2016[45]. The law on budget and fiscal responsibility, which was adopted in 2014, stipulates inter alia that the level of the public debt should not exceed 60% of GDP. When this threshold is exceeded due to the implementation of infrastructure projects and the borrowing for such projects has been sanctioned by the Parliament (as is the case of the highway), the law foresees that the government proposes a plan to reduce public debt back to the target within five years. The authorities' compliance with the exceptional provisos to the rules which they set for themselves will be key to ensure the credibility of the fiscal framework in a medium-term context.

2.2 Inflation, banking sector and financial stability

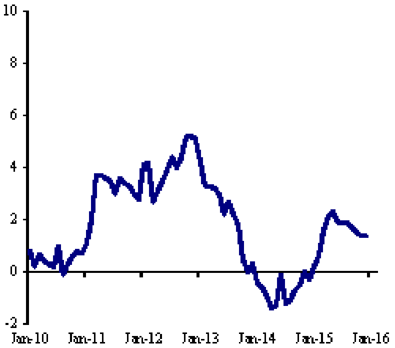
Inflation bounced back in 2015, with authorities projecting a further moderate increase in the medium-term. After an annual decline of 0.7% in 2014, inflation as measured by the CPI increased by 1.5% year-on-year in 2015 (see Chart 4). The increase in CPI inflation stemmed from the introduction of a tax on gasoline aimed at collecting revenues for the highway construction, which more than offset lower

[44] In March 2016 the Montenegrin government has launched a EUR 300mn five-year bond at a 6% yield (as compared with a 4% yield on the previous March 2015 issue).

[45] According to the law, public debt should not exceed 60% of GDP and the budget deficit is to remain below 3% of GDP (borrowing for capital projects could be, however, exempted from the debt rule).

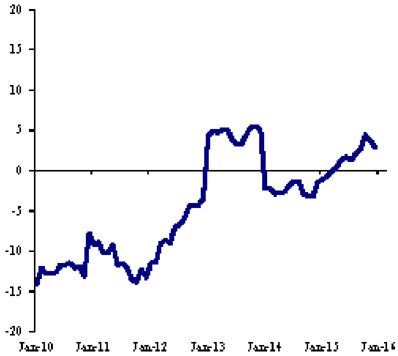
oil prices. As a result, the growth in prices in Montenegro was higher than in most of its regional peers. Looking ahead, the ERP projects inflation to increase to 1.5% in 2016 and 2.0% in 2017. The forecast for 2016 is broadly in line with commercial banks' inflation expectations, while expectations from the corporate sector point to a slightly more subdued outcome in comparison[46]. Risks to the inflation outlook remain broadly balanced, with public sector wage growth amid strong anticipated domestic demand posing upside risks and the withdrawal of the tax on oil and the possibility of lower economic growth than currently expected constituting downside risks.

Chart 4. Consumer price inflation
(annual percentage change)



Sources: Haver Analytics and Monstat.

Chart 5. Private sector credit growth
(annual percentage change)



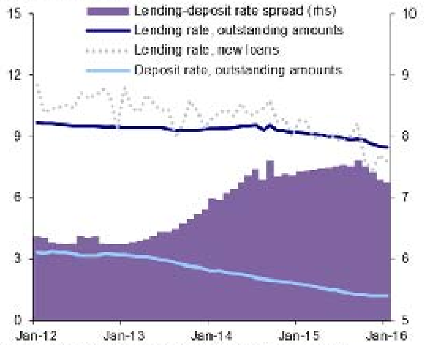
Notes: Private sector covers households and non-financial institutions.
Sources: Central Bank of Montenegro, Haver Analytics and ECB staff calculations.

Lending picked up in 2015, but the persistence of this trend has yet to be ascertained and the cost of credit remains high. Higher lending (to both households and the corporate sector) took place after a protracted period of private sector balance sheet adjustment in the aftermath of the bursting of the credit bubble (see Chart 5). However, it is too early to assess whether this trend will be sustained in time, since the private sector remains highly indebted and credit conditions in the banking sector remain tight overall. The cost of credit remains high, in spite of a mild downward trend in recent months (see Chart 6). Competition in the system remains high, with the number of banks operating in the country being relatively high given the size of the economy and further increasing to 14 in 2015 from 11 in 2013.[47] This suggests that, beyond high unit (operating) costs, the persistence of high lending rates seems mainly associated with the high NPL burdens which remain in banks' balance sheets and legal and regulatory difficulties which hamper both the NPL disposal process and the pace of financial intermediation more broadly

[46] According to the February CBM survey, 11 (out of 14) banks expect inflation between 1 and 2% on average in 2016, while 84% of companies expect inflation below 1.5% on average in 2016. The forecast of inflation presented in the ERP documents concern, however, yoy inflation at the end of 2016.

[47] In February 2016 the central bank issued the licence to the 15th commercial bank.

Chart 6. Commercial banks' lending and deposit rates (in %)



Note: Average weighted lending/deposit rates.
Sources: Central Bank of Montenegro and Haver Analytics.

The banking system appears to be well capitalised overall, but a number of challenges to financial stability remain. The ratio of regulatory capital to risk weighted assets stood at 15.5% in end-2015, compared to 16.2% in end-2014. Risks to banks' funding base have declined, with loan-to-deposit ratios falling to 91.0% in end-2015 from 102.6% in end-2014. In spite of these positive traits, there remain a number of challenges to financial stability. In the near-term, the main risk continues to stem from the burden of non-performing loans on banks' balance sheets, with the ratio of NPLs to total loans remaining high at 13.4% in 2015Q4 notwithstanding its moderate downtrend in recent quarters. NPLs net of provisions to capital – despite a visible improvement in recent quarters – remain elevated overall (36.2% in 2015Q4 against 49.3% in 2014Q4). Bank profitability remains low overall (in 2015Q4 return on equity and assets were negative at -0.7% and -0.1%, respectively[48]). In the medium term, challenges to financial stability include the possibility of domestic fallout related to the on-going restructuring of key banking groups with subsidiaries operating in Montenegro as well as a rising indirect exposure by banks to the sovereign (in the form of holdings of government securities, which in 2015Q4 amounted to 8.3% of total assets as compared with 4.4% in 2014Q4).

Persistently high levels of non-performing loans in banks' balance sheets continue to demand more comprehensive policy action by authorities beyond that taken thus far. Authorities introduced the law on Voluntary Financial Restructuring of Debts to Financial Institutions ("Podgorica approach") in 2015 in order to foster the disposal of bad loans by banks. However, this initiative has received only limited take-up and its focus remains narrow since it does not address the stock of non-performing loans. Banks continue to report a number of difficulties as regards NPL disposal, including the legal and regulatory environment for collateral execution. Risks related to NPLs for both financial stability and financial intermediation thus continue to demand more comprehensive policy action by authorities.

[48] In 2015 banking sector profit was to some extent negatively affected by the Swiss franc-denominated loans obligatory conversion into euros at the exchange rate from the date when the loan agreement was signed. The impact of the conversion on banking sector performance as a whole was, however, limited as only one bank had been providing Swiss franc loans (which amounted to EUR 31.5mn in January 2015, i.e. 1.7% of total loans to private nonfinancial sector in the banking sector).

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and the prospective EU member countries

The 2015 ECOFIN Council conclusions identified a number of areas for further policy action by Montenegrin authorities, including (i) to sustain the commitment to fiscal discipline, establish a credible track record on the basis of the new rules-based fiscal framework and revise the public debt management strategy to bring the public debt into a downward trajectory in line with the ERP medium-term framework and (ii) to address NPL resolution from both a flow and stock perspective, including implementing the planned voluntary financial restructuring programme (the so-called "Podgorica approach") and improving deadlines and efficiency of contract enforcement. Compliance with this policy guidance has been mostly weak. On the fiscal side, public debt has continued to increase and debt dynamics are not seen to stabilise in the years ahead; plans to bring back public debt to 60% of GDP within a five year period (as stipulated in the law on budget and fiscal responsibility) have yet to be devised. Concerning NPLs, the law on voluntary financial restructuring has been implemented; however, its take-up to deal with NPL flows has been limited and measures to tackle the stock of non-performing loans have not been developed.

3. Assessment

Economic growth accelerated in 2015 and the authorities anticipate that activity will remain robust in the period ahead. However, downside risks to this positive baseline appear substantial since activity will be heavily dependent on a single public infrastructure project, in turn implying that risks to the sustainability of both public finances and external accounts remain high. Furthermore, a high degree of uncertainty remains as regards positive spillovers from the highway project to the real economy. The authorities' choice of monetary and exchange rate policy framework will continue to imply that sound fiscal policies and flexible labour and product markets are essential to safeguard macroeconomic and financial stability and improve competitiveness. Against this background, the following aspects are worth highlighting.

Fiscal space has largely been exhausted and infrastructure projects will continue to put high pressure on the public balance sheet going forward, raising questions about the sustainability of public finances unless credible consolidation measures are taken. This implies that consolidation measures targeting government expenditure are strongly warranted. The need to re-build fiscal buffers is further augmented by the high sensitivity of public debt dynamics to growth and interest rates assumptions going forward. The authorities' general commitment to expenditure-based consolidation needs to be underpinned by concrete and credible measures in the period ahead to buttress the sustainability of public finances and contain broader economic and financial stability risks.

The credibility of the authorities' rules-based fiscal framework is at risk of being jeopardised. Exceptions to rules were made from the outset on account of capital spending-related items. As the public debt-to-GDP ratio exceeded 60% in 2015 authorities should develop a credible plan to bring back public debt within five years to below this threshold again in line with the framework which they set for themselves.

Within its limited degrees of policy freedom, an upgrade of the central bank's analytical and policy tools should be encouraged. In this context, the establishment of a bank lending survey would help to better gauge underlying credit dynamics. The authorities' intention to develop a macro-prudential framework would also be welcome so as to buttress the stability of the financial system. The enhancement of the existing framework for emergency liquidity provision by the central bank could also be considered in this regard.

A comprehensive strategy to foster the disposal of non-performing loans by banks should be developed. The banking system appears to exhibit robust capital buffers, but challenges to banks' asset quality in the form of high non-performing loans continue to linger and this is also impinging on bank profitability. Although authorities have taken steps to reduce the flow of NPLs through a law on voluntary restructuring, its take-up by banks has been limited and the problem of the stock of bad loans remains unaddressed. Both NPL burdens and provisions differ sizably across banks, suggesting that there would be merit for authorities to plan for an independent asset quality review to take place. This should be embedded in a comprehensive strategy to foster the resolution of NPLs – including the participation of all key stakeholders in the system as has been done by some peer countries. Policy action on the regulatory and legal bottlenecks which are perceived to be hampering the disposal of non-performing loans by banks (including collateral execution) should not only be positive for financial stability but also for financial intermediation more generally, including to bring down the high cost of credit which prevails in the system.

Serbia

1. Monetary and exchange rate policy framework

The main objective of the National Bank of Serbia (NBS) is to achieve and maintain price stability. Without prejudice to its primary objective, the NBS also contributes to the maintenance and strengthening of the stability of the financial system. Moreover, another important role is the integrated supervision of the financial sector.

The NBS aims to achieve price stability through an inflation targeting framework. The inflation target is defined in terms of annual percentage changes in headline inflation as measured by the consumer price index. In cooperation with the government, the NBS has set the inflation target until the end of 2018 at 4.0% within a symmetric 1.5pp tolerance band. As regards accountability, the NBS is required to notify the government (through a public letter) if the actual inflation rate has departed from its target for longer than six consecutive months, and to present policy actions to be taken. The NBS pursues a managed floating exchange rate regime, intervening in the foreign exchange market in order to smooth excessive volatility of the Serbian Dinar, to ensure financial stability and to maintain an adequate level of international reserves.

The main monetary policy instrument is the key policy rate applied in the NBS main open market operations – notably the 1-week reverse repo transactions – to temporarily change the liquidity conditions of the banking system. As of July 2012, main open market operations have been conducted as variable interest rate auctions, with the key policy rate currently being the maximum rate applied. The ceiling and floor of the interest rate corridor in the interbank market are defined by the respective interest rates of the standing facilities. The NBS also resorts to changes in reserve requirements as well as fx operations, including fx swap transactions, in order to influence the monetary policy transmission mechanism.

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

The economy moderately recovered in 2015, with growth driven by strong investment and net exports. The Serbian economy started to recover from the recession of 2014 in 2015Q2, with real GDP expanding by 0.7% in 2015 as a whole (see Chart 1). Growth was mainly driven by a strong rebound of investment as well as by net exports. However, consumption weighed down on overall economic activity, posting a negative rate of growth in the year as a whole due to declining real wages and pensions amid fiscal consolidation efforts by authorities. Looking at the sectoral contributions to growth, the pick-up in activity was broad-based, with robust growth in energy and mining, which recovered from the floods in 2014, as well as in manufacturing export-oriented industries and construction. Agricultural output dropped by 8% due to the effects of a draught.

Chart 1: Contribution to real GDP growth
(annual percentage change in real GDP)

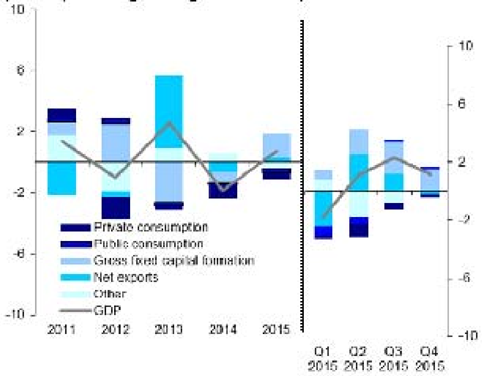
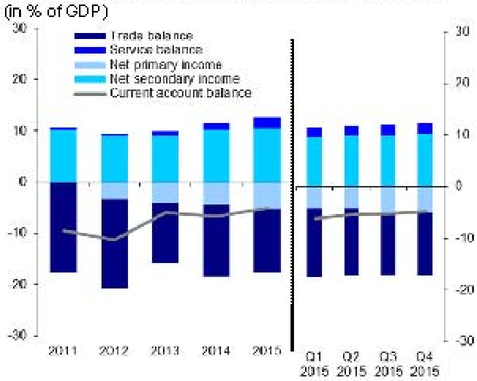


Chart 2: Components of current account balance
(in % of GDP)



Note: Quarterly figures are moving sum of the most recent four quarters.
Sources: SORS, Haver Analytics and ECB staff calculations.

Authorities expect growth to accelerate further in the period ahead. The ERP document anticipates that real GDP will expand by 1.8% in 2016 which is more optimistic than the EC forecast[49], with investment remaining a key driver of economic activity (reflecting an improvement in the business environment, higher FDI and a number of public infrastructure projects) and a slow but steady recovery of private consumption. Looking further ahead, authorities foresee real GDP growth rising by 2.2% and 3.5% in 2017 and 2018, respectively. Risks to the authorities' baseline forecast appear tilted towards the downside on account of both domestic and external factors, including a more protracted implementation of reforms than currently foreseen as well as a more subdued recovery in the international environment than expected at present.

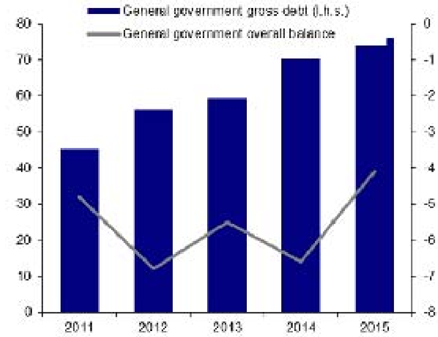
External imbalances continued to narrow in 2015, with the current account deficit edging down to 4.8% of GDP in 2015 from 6.1% of GDP in 2014 (see Chart 2). Part of the improvement was attributable to an increased surplus in the service balance, reflecting positive developments in the tourism sector, with higher remittances also contributing to this outcome. The deficit of the goods balance also narrowed slightly to 12.2% of GDP in 2015 from 12.6% of GDP in 2014 as increased imports due to investment growth were more than offset by higher exports amid a gradual recovery in external demand. On the financing side, FDI rose by 20.2% in 2015, amounting to 5.5% of GDP and thereby covering the current account deficit in full. Gross external debt increased to around 80% of GDP (by September 2015), mainly resulting from exchange rate movements negatively affecting public sector debt (see further below). Looking ahead, authorities expect the current account deficit to decline on the back of a further recovery in external demand and continued increases in tourism revenues.

The fiscal position has markedly improved under the Fund-supported programme. In 2015, the overall budget deficit amounted to 3.7% of GDP (see Chart 3), which is lower than both the 5.9% of GDP deficit target initially foreseen in the IMF programme and the 6.7% of GDP deficit posted in 2014.Fiscal

[49] The EC projects 1.6% growth in 2016 and 2.5% in 2017, while the IMF forecast is in line with the ERP.

consolidation under the Fund-supported programme has been achieved on the expenditure side with linear cuts in public sector wages and pensions, but unplanned under-execution of investment also contributed to curbing expenditures. However, subsidies were 31% higher than originally budgeted, including as a result of a state takeover of Srbijagas debt from previous years. Higher revenues (reflecting improved collection, but also one-off non-tax revenues) also contributed to fiscal consolidation. Authorities have used part of the fiscal overperformance to finance additional one-off expenditures, as well as engage in limited increases in pensions and (some) public sector wages.

Chart 3. Government gross debt and balance
(in % of GDP)



Note: ERP expected figure for 2015.
Source: Ministry of Finance and ECB staff calculations.

Authorities foresee further fiscal consolidation in the period ahead, but implementation risks remain high and this might also impinge on public debt dynamics. Authorities foresee a structural adjustment of 0.75% of GDP per annum over 2016-2017 under the stand-by arrangement with the IMF, which, if realised, would bring the structural fiscal adjustment to 4% of GDP over the lifetime of the programme. The fiscal adjustment in 2015 amounted to 2.4% of GDP in structural terms. Though less ambitious in comparison, achieving the remaining adjustment targets might be challenging since key sources of consolidation – such as the linear cuts in wages and pensions that were undertaken in November 2014 – appear as exhausted. Going forward, consolidation measures will mostly rely on the planned downsizing of the public workforce (which has been delayed in the past years) as well as on increased taxes on electricity and oil products, and reduced agricultural subsidies. Risks to the foreseen consolidation path mostly relate to a weaker implementation of key measures to curb expenditures than currently envisaged, including less downsizing of the public sector workforce than planned, a larger drag on the budget from loss-making SOEs than currently foreseen or difficulties in cutting subsidies. In addition, higher than currently foreseen costs related to 'transit' migration flows might also impinge on the fiscal outlook to the extent that these are not fully reimbursed by international or regional external stakeholders. Weaker economic activity than currently foreseen and less success in the fight against informality in the economy than projected would add to risks on the revenue side. The extent to which the authorities' fiscal baseline materialises will also influence public debt dynamics going forward, which have yet to stabilise notwithstanding the decline in the budget deficit. General government debt increased to 75.5% of GDP at the end of 2015 from 70.4% of GDP in 2014, mainly on account of the depreciation of the dinar against the USD[50]. Looking ahead, authorities anticipate that public debt to GDP will peak at 79.1% of GDP in 2016 and thereafter be put on a downward path, falling to 75.7% of GDP in 2018. Debt

[50] With external debt making up 61% of total public debt (staying roughly constant during 2015), around one third of public debt is denominated in USD.

dynamics will remain vulnerable to both exchange and interest rate risks, since more than 70% of debt is denominated in fx and financing needs will continue to be high.[51]

2.2 Inflation, exchange rates, monetary policy and financial stability

Inflation remained below the central bank's target in 2015 on account of external and domestic factors. At 1.4% year-on-year in 2015 as a whole (1.5% year-on-year in December) inflation remained significantly below the lower bound of the central bank's tolerance band throughout 2015 (see Chart 4). Low inflation partly reflected external factors such as the decline in global oil and food prices but also weak pressures from subdued domestic consumption. Looking forward, the NBS expects inflation to remain around the lower bound of the tolerance band until mid-2016 and to accelerate thereafter, with the 4% central target anticipated to be reached by the end of 2016 or the first half of 2017.

Chart 4. CPI inflation
(annual percentage change)

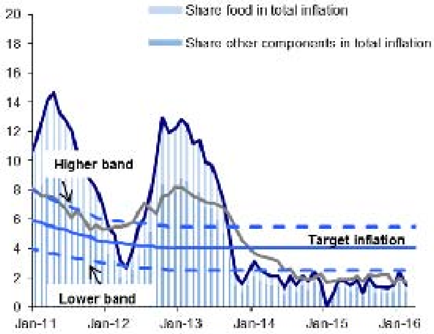
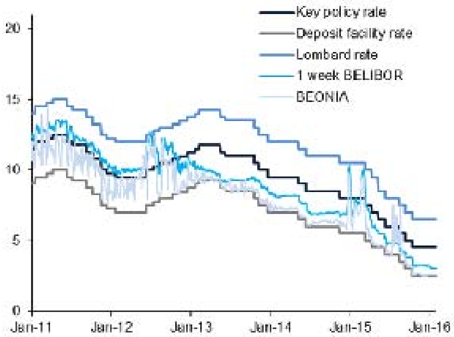


Chart 5. Interest rates
(in %)



Note: Core inflation excludes energy, food, tobacco and alcohol.
Sources: Haver Analytics, NBS and ECB staff calculations.

The central bank continued to relax its monetary policy stance, with room for policy easing partly afforded by progress in fiscal consolidation. Coupled with low inflation, progress with fiscal consolidation enabled the central bank to step-up the pace of its policy easing cycle in 2015, with the NBS cutting its key interest rate by a cumulative 350 bps throughout 2015 and by a further 25 bps in February 2016, bringing down its benchmark interest rate to a historic low of 4.25% (see Chart 5). Monetary easing was reinforced by a six-fold decrease in fx reserve requirements to 13% for liabilities with maturities of over two years and 20% for liabilities with maturities up to one year. The gap between the key policy rate and average weighted interest rate on repo sold securities[52] by the central bank has remained sizeable as the NBS continued its policy of limited absorption of commercial banks' liquidity

[51] Refinancing needs for 2016 amount to EUR 5.4bn of which EUR 3.7bn are planned to be raised on the domestic market and the remaining EUR 1.7bn on the external market, possibly by a Eurobond of EUR 1bn.

[52] The average rate of the main open market operations which are conducted at variable rate tenders.

surpluses (see Chart 5). In order to start redressing this discrepancy, the NBS narrowed its interest rate corridor by 25bps to ±1.75% relative to the key policy rate in February 2016, as the average reverse repo rate cannot fall below the deposit rate. The NBS continued to intervene heavily in the fx market, but, contrary to what was the case in 2014, buy-side interventions were dominant throughout 2015 with net fx purchases of EUR 520mn (see Chart 6). Looking ahead, the NBS appears to have room to continue with its policy easing cycle should convergence of both inflation and inflation expectations to the central target be more protracted than currently foreseen. In this regard, the results from the NBS inflation report for February 2016 suggest that private sector inflation expectations – which have been sizeably trending down in 2015 – are lagging behind the central bank's own forecast for inflation going forward, especially at the one-year horizon. However, such policy action would remain partly contingent on further progress as regards fiscal consolidation.

Chart 6: Exchange rate and NBS interventions

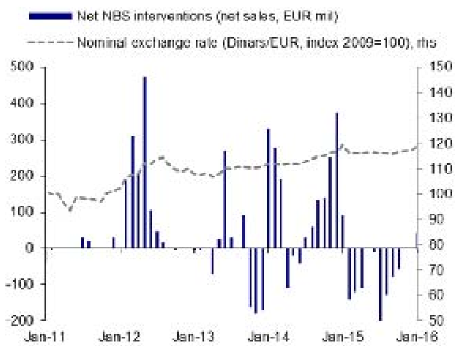
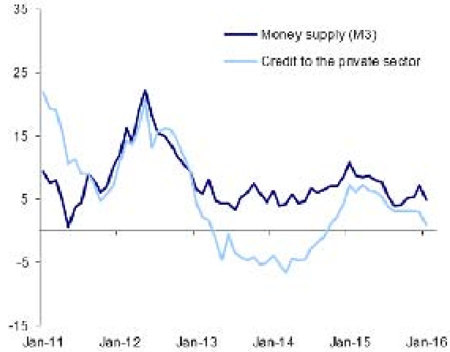


Chart 7: Money and credit growth
(annual percentage change)



Sources: Haver Analytics, NBS and ECB staff calculations.

Bank lending picked up in 2015, including as a result of a lower cost of financing, but the pace of credit extension moderated throughout the year. Credit growth recovered from its 2014 trough and remained in positive territory in 2015, averaging 4.9% for the year as a whole, with lending to the household sector remaining more dynamic than that to corporates (see Chart 7). In turn, this partly reflected a lower cost of credit on account of both monetary policy easing and higher competition among banks with average weighted rates on new dinar loans declining to 8.8% at end-2015, from 12.6% at end-2014. As average weighted rates on new euro loans dropped less in comparison, the spread between dinar and euro loans narrowed to 4.5 percentage points in December 2015, from 7.5 percentage points at end-2014. However, the pace of credit extension moderated through the course of the year, partly reflecting sizeable repayments falling due from the 2014 subsidised lending scheme.

The banking system is highly liquid and well capitalised overall, but a solution for smaller non-systemic entities has yet to be found. The results of the special diagnostic studies – which were undertaken in the context of the Fund-supported programme – confirmed that the banking system remains well-capitalised from a systemic point of view. All participating banks (14 out of 30 banks in the system, covering 88% of total banking sector assets and including all Greek-owned subsidiaries) were found to have a capital adequacy ratio above the regulatory minimum of 12% with the aggregate capital adequacy ratio for the system as a whole at 18.45% (down 1.76pp relative to the pre-special diagnostics figure)[53]. Risks to banks' funding base have stabilised, with total loan-to-deposit ratios remaining at around 100% throughout 2015, and reliance on parent funding accounting only for a fraction of bank liabilities. Spillovers from financial turmoil in Greece through Greek-owned bank subsidiaries operating in Serbia (which together account for around 13% of total banking system assets) were limited in 2015 thanks to prudent regulatory measures undertaken by the NBS[54]. However, pockets of vulnerability remain in a few smaller entities that are state-owned and were not part of the special diagnostics studies, for which a solution (privatisation or resolution of 5 out of 30 state-owned banks) has yet to be found. Additionally, in the medium-term risks might emerge from a restructuring of the parent banks of some subsidiaries.

Challenges to banks' asset quality, which remain sizeable, are being addressed through a comprehensive NPL resolution strategy. Despite ample capital and liquidity buffers for the banking system as a whole, challenges to banks' asset quality remain a key concern for both financial stability and financial intermediation. The ratio of NPL to total loans, while trending down in 2015, remained high at 24.4% in October 2015, as compared to 21.5% in end-2014. This downtrend is fully attributable to the corporate non-performing loan segment – which accounts for the majority of NPLs – as bad loans in the household sector have yet to peak. Moreover, notwithstanding adequate total loan provisioning, NPLs net of provisions to capital remained high at 28.4% in October 2015, from 31% in December 2014. In order to help resolve this long-standing challenge, authorities have developed a comprehensive NPL resolution strategy[55].

Fostering the use of the local currency in the financial system continues to deserve attention by authorities to fend-off risks to financial stability and enhance the effectiveness of monetary policy. Authorities have been taking a number of initiatives to foster the use of the dinar in the banking system in recent years under their dinarisation strategy, including through differentiated reserve requirements for fx and local-currency denominated liabilities and subsidised dinar loan programmes. However, in spite of such efforts, progress to reduce asset and liability euroisation in the banking system has been only gradual. On the bank asset side, 2015 saw an increase in dinar loans for households, but this was more than offset by a drop in dinar loans to the corporate sector (mainly linked to the end of the

[53] As follow-up to the special diagnostics exercise, micro-level qualitative assessments of credit policies and recommendations for collateral treatment and provisioning are being prepared.

[54] The measures which were introduced in June 2015 included enhanced monitoring and limitation of transactions between Greek-owned banks and their parent banking groups. These measures were partly relaxed in December 2015.

[55] The part of the action plan for which the NBS is responsible for aims to strengthen banks' capacity to resolve bad loans, inter alia by enhancing accounting standards and practices including IAS 39 implementation on impairment and uncollectability of exposures (of which guidelines have been published by the NBS at the end of February 2016) and improving collateral valuation. The part of the action plan for which the government is responsible foresees *inter alia* reforms of the insolvency framework, an improvement in out-of-court restructuring processes, the development of distressed asset markets by allowing specialised companies to operate and amendments in tax policy. Thus far, the publishing of IAS 39 guidelines and the planned amendments to the lawon mortgages were implemented.

subsidised credit scheme), which pushed up the ratio of fx loans to total loans to 71.4% in December 2015, from 68.8% in December 2014[56]. On the side of bank liabilities, fx deposits decreased marginally in 2015 but remained high, accounting for around 72% of total banking sector deposits. Taken together, these developments suggest that fostering the use of the local currency in the banking system should remain high on the authorities' policy agenda for 2016 and beyond. Further success on this front should not only be net positive for financial stability but also contribute to a more efficient transmission of monetary impulses by the central bank to the real economy.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and prospective EU member countries

The 2015 ECOFIN Council conclusions identified a number of areas in need of further policy action by Serbian authorities, including (i) strengthening fiscal consolidation in 2015 and the following years, including as a pre-condition to facilitate a more accommodative policy stance by the central bank; (ii) advance the restructuring and privatisation of state-owned enterprises; and (iii) increase efforts to address the high burden of NPLs. Compliance with this policy guidance has been generally positive. In the fiscal realm authorities made good progress to reduce the budget deficit and thereby created room for the central bank to ease monetary policy more than hitherto. Some progress was also made as regards the restructuring and privatisation of state-owned enterprises, although a number of challenges remain (which also became apparent in the failed privatisation of Telekom Srbija in December 2015). As regards bad loans, authorities developed a comprehensive strategy for NPL resolution involving relevant stakeholders, on which follow-up has recently begun.

3. Assessment

Serbia has implemented reforms in various sectors. This was a key factor behind the return to real growth in 2015, and a continuation of the reform path which authorities have recently embarked on is key to underpin the expected acceleration in growth going forward and to foster sustainable convergence.

The fiscal position has markedly improved, but sustained efforts are warranted to put public finances on a sustainable footing. The fiscal over-performance achieved in 2015 was encouraging, in particular as a large part of the consolidation recorded in structurally-adjusted terms was attributable to the cuts in public salaries and pensions. However, the unplanned under-execution of public investment implies that the management of public investment (including prioritization, implementation and evaluation) should be improved in order to avoid detrimental effects for long-term growth. Looking ahead, further consolidation largely hinges on the ability to press ahead with plans for the rightsizing of the public sector, as well as on the reform of some strategically important SOEs. Coupled with efforts to improve the business environment, progress in these areas should also pave the way for an increased contribution of the private sector to growth. However, the scope for policy slippages inherent to these reforms suggests that a sustained effort will be needed on the part of authorities in order to cement the sustainability of public finances going forward, in a context where the large public debt burden has yet to stabilise in

[56] The share of fx loans contains mostly loans denominated in or indexed to euro, as the share of loans indexed to the Swiss franc in total loans was only 5.7% at the end of 2015 (decreasing from 6.8% at the beginning of the year).

relation to GDP. The establishment of a credible rules-based fiscal framework would also be helpful to anchor fiscal policy beyond the lifetime of the Fund-supported programme.

The central bank has rightly pursued an accommodative monetary policy stance, with further easing going forward partly contingent on sustained fiscal consolidation. Faced with below-target inflation and inflation expectations as well as output being below potential, the central bank stepped-up the pace of its monetary policy easing in 2015. The sizeable progress on fiscal consolidation was a key element to underpin this policy stance by the NBS, inter alia by reducing tail risks for financial stability associated with potentially adverse exchange rate developments amid high euroisation in the economy. The discrepancy between the key policy rate and the average reverse repo rate faced by commercial banks has remained, but the central bank has recently begun to redress this. Looking ahead, further policy easing by the central bank continues to be largely predicated on anchored inflation expectations amid a favourable fiscal consolidation path.

The banking system remains sound overall, but pockets of vulnerability should be addressed. The conduct of the special diagnostic studies for the banking system was helpful to confirm that the systemically-important part of the banking system remains sound and well-capitalised, notwithstanding lingering challenges to banks' asset quality. As authorities continue to follow-up on the qualitative recommendations stemming from this exercise, shedding increased light on the position of smaller banks that fell outside the remit of the diagnostic studies would be welcome, including plans for the resolution or privatisation of a few state-owned entities.

Progress with the implementation of the authorities' NPL resolution framework and further efforts to promote the use of the local currency should be made to enhance financial stability, financial intermediation and the effectiveness of monetary policy. The adoption of a comprehensive NPL resolution strategy, involving relevant stakeholders, was an encouraging step to address a long-standing challenge in the banking system. Going forward, the implementation of the various elements of the action plan specific to the NBS and the government will remain key. Although authorities also have a dinarisation strategy in place and a number of measures have been taken to promote the use of the local currency in the system, relative progress on this front has been only gradual. Buttressing this strategy with other elements, including to foster local capital market development, might thus be warranted. Taken together, progress on both NPL resolution and the promotion of the local currency in the financial system would help to fend off financial stability risks and increase the effectiveness of monetary policy.

Turkey

1. Monetary and exchange rate policy framework

The primary objective of the Central Bank of the Republic of Turkey (CBRT) is to achieve and maintain price stability. To this end, the CBRT adopted an explicit inflation targeting framework in January 2006, following a period when inflation has been targeted implicitly between 2002 and 2005 in order to reduce annual price increases from the high double-digit rates recorded in the early 2000s. Turkey's exchange rate arrangement is classified as a floating regime[57] with direct interventions limited to smoothing excessive volatility and pre-announced foreign currency auctions conducted to either bolster foreign exchange reserves or to alleviate shortages of foreign currency liquidity. The CBRT's monetary policy decision-making body is the Monetary Policy Committee. Banking supervision is the responsibility of the Banking Regulation and Supervision Agency (BRSA).

The inflation target is set for a three-year period in terms of year-end headline inflation as measured by the consumer price index. For 2016-2018 the inflation target has been set at 5.0% surrounded by a ±2% band. If year-end inflation falls outside this band, the CBRT has to submit an open letter to the government, explaining the reasons for the departure from target and the measures (to be) adopted in response.

Since October 2010, the CBRT has progressively followed a policy mix dubbed "flexible inflation targeting". Without prejudice to its primary objective of price stability, additional policy goals have been adopted at various points in time, including managing the growth and structure of domestic credit, addressing balance of payments issues, such as current account developments or the amount and composition of foreign capital flowing into Turkey, or preventing undue exchange rate and output volatility. In order to meet these multiple objectives a wide and complex range of instruments have been put into operation. In addition to the actual policy rate (i) an interest rate corridor is in place which – in combination with the liquidity offered at the policy rate – provides the CBRT with more policy flexibility to fine-tune money market rates as well as to reduce their predictability; (ii) reserve requirement ratios are staggered according to the maturity and currency denomination of banks' liabilities; (iii) a reserve option mechanism (ROM) exists giving banks the possibility to hold a share of their reserve requirements in US dollar and gold with a system of reserve options coefficients (ROC) guiding the costs of using the ROM[58]; and (iv) direct foreign exchange interventions and foreign exchange auctions are conducted. This array of instruments has been modified over time to optimise the selection and the functioning of the tools at the CBRT's disposal.

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[57] According to the IMF classification of de facto exchange rate arrangements.

[58] The ROM allows banks to hold a certain share of their required reserves in US dollar or gold instead of Turkish lira. Exercising this option comes at a cost that is determined by the ROC which indicates the amount of foreign currency or gold to be held for each unit of Turkish lira. The ROM was introduced by the CBRT in September 2011 to reduce the adverse impact of volatile capital flows on the exchange rate and on credit growth. It is considered by the CBRT to be superior to standard foreign exchange interventions as the withdrawal of foreign currency liquidity from the market is based on the optimising behaviour of individual banks weighing the relative cost of domestic versus foreign currency reserve holdings rather than on a decision by the central bank about the amount of reserves to be purchased or sold which may also provoke speculation against a perceived exchange rate target. Starting in October 2012 the CBRT also began using the ROC as a macro-prudential tool.

2. Economic and financial developments

2.1 Economic growth, external sector and fiscal developments

Economic growth has accelerated notably to 4.0% in 2015 on the back of strong private consumption, following subdued growth of 3.0% in the previous year (see Chart 1). Contrary to market expectations, real GDP growth picked up in the course of 2015, with real GDP growth reaching 4.4% (y-o-y) in the final quarter. In 2015 as a whole, annual growth amounted to 4.0% and was primarily driven by household consumption (contribution of 3.0 pp), but also by government consumption (0.7 pp) and gross fixed capital formation (0.9 pp), while net exports contributed negatively to growth (-0.3 pp).

Chart 1. Contributions to real GDP growth
(annual percentage change in real GDP)

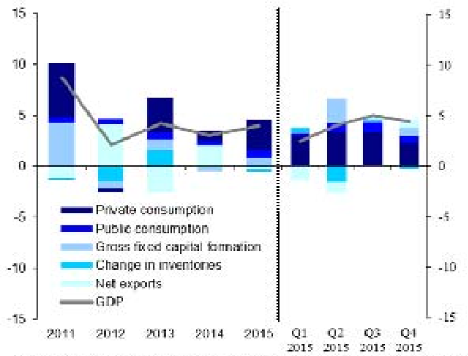
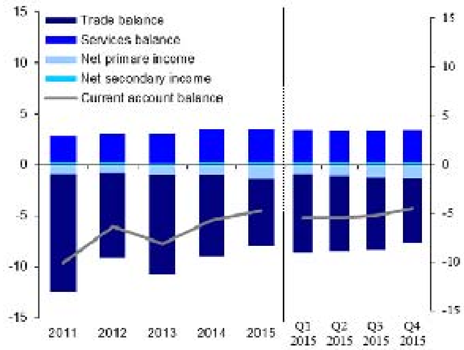


Chart 2. Components of current account balance
(in % of GDP)



Notes: Quarterly figures for the current account balance are a moving sum of the most recent four quarters. In the case of contributions to real GDP growth, annual growth with respect to the same quarter a year earlier (seasonally and working days adjusted).
Sources: Turkish Statistical Institute, Haver Analytics and ECB staff calculations.

The strength in domestic demand came as a surprise, as consumer confidence plunged to very low levels prior to the two elections in June and November. Nevertheless, private consumption benefited from (1) strong real wage growth, (2) the income effect from the oil price decline, (3) a wealth effect from the TRY depreciation, since a considerable share of deposits is denominated in foreign currency, and (4) the additional demand from refugees (currently estimated at 2-2.5 million). Despite of strong domestic demand, imports fell more strongly than exports towards year-end 2015, but trade has remained very weak in line with subdued global developments.

For 2016, the Turkish authorities anticipate continued strong GDP growth. According to the government's medium-term programme 2016-2018, published in January, GDP is projected to increase by 4.5% in 2016 and 5.0% in 2017-2018. In particular, the recent decision to increase the minimum wage by 30% will boost GDP growth in 2016 by around 1 pp. Thus, growth will remain domestic demand-driven this year, while authorities expect more balanced contributions from domestic and external demand in 2017-2018, although the short- to medium term outlook for Turkey's external demand remains subdued. Compared to the projections in the medium-term programme, forecasts provided by other institutions are somewhat less optimistic. Latest consensus figures (February) put GDP growth at 3.2% in 2016, while international institutions are slightly more optimistic (but still well below the authorities' projection of 4.5%) with the IMF projecting real GDP growth in 2016 at 3.8% (Article IV consultation, March), the European Commission at 3.4% (Winter Forecast, February) and the World Bank at 3.5% (World Economic Prospects, January). The risks to the authorities' forecast are therefore clearly tilted to the downside, and the Turkish economy remains heavily dependent on global financing conditions, which constitute additional downside risks. In particular, weak business climate and problems related to the rule of law have led to weak investment in recent years, weighing on potential growth. Turkey has to create about 1 million jobs per year to absorb the population growth and the increase of the labour participation rate. Growth at 3.5%, however, would be insufficient to create the jobs needed to hold the unemployment rate constant, and structural reforms are therefore key for the Turkish economy.

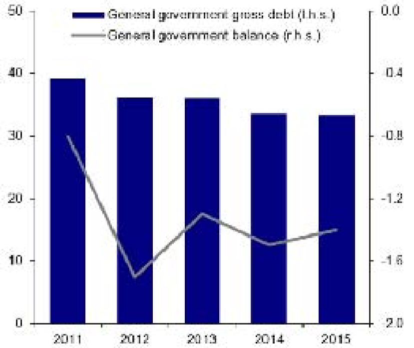
The external sector remains the Achilles' heel of the Turkish economy. Following its peak at 9.6% of GDP in 2011, the current account deficit has narrowed and reached 4.5% of GDP in 2015, down from 5.4% in 2014. This adjustment, however, was mostly driven by the improvement in the terms-of-trade as a result of the fall in global energy prices and a normalisation in Turkey's net gold trade, which have more than offset the TRY depreciation in the past year. In fact, the improvement in the current account balance to 4.5% in the final quarter of 2015 (see Chart 2)[59], down from 7.7% two years earlier, was entirely due to these two factors, while the current account deficit excluding gold and energy remained broadly unchanged over this period. In this respect, the structural reduction of the savings-investment gap is one of the main challenges for the new government. For 2016, the government's medium-term programme foresees the current account deficit to fall to 3.9% of GDP, which seems achievable against the backdrop of still low energy prices.

Moreover, notwithstanding some positive one-off factors, net foreign direct investment (at 1.6% of GDP) still only covers a small share of the current account deficit, while Turkey has even experienced net portfolio outflows in recent quarters (amounting to 2.2% in the fourth quarter of 2015). The external funding needed to finance the current account shortfall is therefore still predominantly sourced from short-term debt-creating (net) other investment flows (2.1% of GDP). As a result, Turkey's gross external debt has climbed to 54.8% of GDP in the third quarter of 2015, up from 50.4% at the end of 2014, with banks expanding their external liabilities from 20.7% to 23.1% of GDP. Overall, balance of payments developments up to end-2015 led to a fall of reserve assets amounting to 1.6% of GDP in the past year (see also footnote 6). Against the backdrop of the recent portfolio outflows and decreasing foreign currency reserves, as well as the global uncertainty regarding further diverging monetary policies, the current account deficit financing remains an important issue for Turkey, with a sudden capital flow reversal being a main downside risk for the economy – in particular if the government proves unable to implement urgently needed structural reforms to increase the national saving rate.

[59] All quarterly balance of payments figures are reported as moving sums over the most recent four quarters of available data.

Notwithstanding the expected slight increase in the budget deficit in 2016, fiscal policy is judged to remain sustainable with a continued decrease in the debt-to-GDP ratio over the medium term. The European Commission's estimate of the general government budget deficit[60] is 1.4% of GDP in 2015 (see Chart 3), before slightly deteriorating in 2016 (1.7%) and 2017 (1.6%). In the light of a primary surplus and high nominal GDP growth over the medium term, public debt sustainability is not an issue, with the general government gross debt ratio expected to drop from 33.5% in 2014 to 31.4% in 2017. However, the increase in the budget deficit – mainly due to new spending related to election promises and a temporary labour subsidy to cushion the impact of the increase in the minimum wage – contributes to a widening of the savings-investment gap and thus of the external imbalances in Turkey. Hence, while public finances remain overall sound, a tighter fiscal policy stance is still warranted to rebalance the economy from both an external (current account deficit) and an internal (high inflation) perspective.

Chart 3. Government gross debt and balance
(in % of GDP)



Source: European Commission (figures for 2015 are estimates).

2.2 Inflation, exchange rates, monetary policy and financial stability

Inflation has persistently stayed above the upper (7%) bound of the CBRT's uncertainty band, and inflation expectations seem increasingly de-anchored. Notwithstanding the sharp drop in energy prices since mid-2014, the CBRT has clearly missed its inflation target in 2015. Headline inflation has exceeded the inflation target (5%) persistently in the past years and has even overshot the upper bound of the CBRT's uncertainty band (7%) almost continuously since mid-2011, standing at 8.8% y-o-y in February 2016 (see Chart 4). The CBRT mentioned the pass-through from the strong depreciation of the Turkish Lira (TRY, see Chart 5) and a structurally elevated inflation in food prices – which have a weight of almost 25% in the CPI basket – as the two main factors for missing the target. The official projection by the CBRT (and also in the government's medium-term programme) expects inflation to decline to 7.5% by end-2016, which is still outside the target range, but well below the latest inflation expectations of 8.5% for year-end inflation.

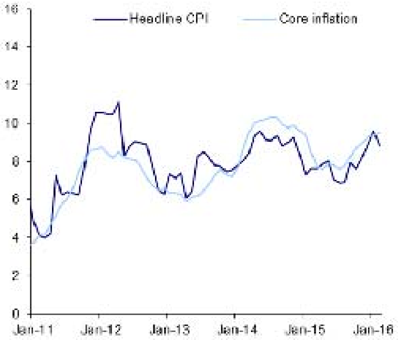
In spite of inflation persistently above target and further rising inflation expectations, the CBRT left its main policy rate unchanged since its rate cutting cycle had ended in February 2015 (see Chart 6). While the main policy rate, i.e. the one-week repo rate, was left unchanged at 7.5% since February 2015, the CBRT adjusted its liquidity operations to guide interbank funding costs towards the upper end of its interest rate corridor at 10.75%. For this reason, the CBRT assesses its current policy

[60] The budget deficit reported by the Turkish authorities in the medium term programme is somewhat lower, amounting to 0.0% of GDP in 2015 and -0.7% in 2016 and 2017. As those numbers are however not compliant with the ESA 2010 standard, we use the numbers reported by the EC's winter forecast instead.

stance as being tight with respect to the inflation outlook. More precisely, by decreasing the liquidity operations via the one-week repo facility and by increasingly relying on marginal lending, the weighted average cost of funding increased by more than 100 bps in the last year. In the MPC meeting in end-March, however, the CBRT lowered the overnight lending rate by 25 bps, slightly narrowing the interest rate corridor from the upper end.

Borrowing rates for both commercial and consumer loans increased significantly in the course of 2015, as Turkish banks tend to price loans off the overnight lending rate if liquidity is scarce. As a result, loan growth weakened somewhat, with commercial loans continuing to grow at a faster rate compared to consumer loans.

Chart 4. Consumer price inflation
(annual percentage change)



Note: Core inflation excludes unprocessed food, energy, alcoholic beverages, tobacco products and gold.
Sources: Turkish Statistical Institute and Haver Analytics.

Chart 5. Nominal exchange rate
(Turkish lira per euro)

Sources: Central Bank of the Republic of Turkey and Haver Analytics.

Apart from modifications to liquidity conditions the CBRT also relied on its other instruments to achieve its policy goals. Most notably, the CBRT released a road map in August 2015 regarding the policies to be implemented before and during the normalization of global monetary policies, including the narrowing of the interest rate corridor and various measures in the context of TRY liquidity, foreign exchange liquidity and financial stability. Reacting to the uncertainties in global monetary policies and its effects on foreign exchange markets, the CBRT gradually lowered the interest rates on FX deposits that banks can borrow from the CBRT within their borrowing limits at the FX deposit market. Moreover, transaction limits for banks at the CBRT Foreign Exchange and Banknotes Markets were raised. Additionally, the flexibility of foreign exchange sales auctions was enhanced against the volatility in global financial markets. In order to extend the maturity of the external debt of the banking system and to cope with the upward trend in the share of non-core liabilities, the CBRT introduced a number of measures with regard to foreign exchange required reserves and remuneration rates on the required reserves maintained in TRY. Additionally, changes made to the guidelines for the use of FX deposits as collateral have somewhat lowered banks' need for swap deals with the market. Notwithstanding the significant stock of international reserves held by the CBRT, the recent acceleration of portfolio outflows constitutes a significant downside risk in an environment of diverging global monetary policies and the associated elevated level of global risk aversion, since net FDI inflows remain low and the CBRT has recently used its international reserves to finance part of the current account deficit. At the end of 2015, the CBRT held gross international reserves worth USD 133 billion, which corresponded to a decrease of USD 9 billion as compared to 2014. However, according to ECB staff calculations, about USD 79 billion of these assets are directly attributable to Turkish banks (a part of them replacing required lira reserves via the ROM) [61], leaving the central bank with only USD 36 billion of liquid foreign currency reserves at its disposal once its USD 18 billion of gold holdings are taken into consideration.

Chart 6. Interest rates
(in %)

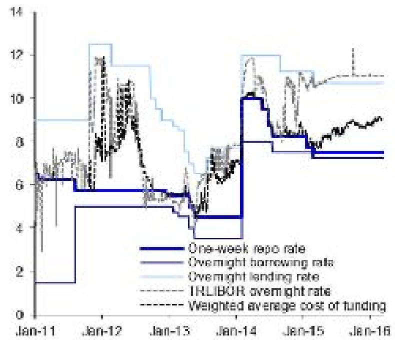
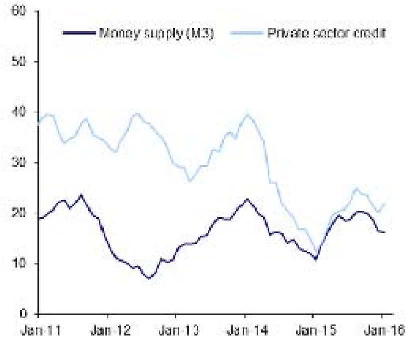


Chart 7. Money and credit growth
(annual percentage change)



Sources: Central Bank of the Republic of Turkey and Haver Analytics.

Turkey's banking sector seems overall stable with still high capital adequacy (CAR) and low non-performing loan (NPL) ratios, but the high loan-to-deposit (LTD) ratio still implies funding risks. While both bank profitability and capital adequacy ratios are on a downward trend since 2009, not least due to strong credit growth in recent years (see Chart 7), indicators have remained fairly robust in 2015. In December 2015, the CAR of the banking sector stood at 15.6%, corresponding to a mild decline from 16.3% at end-2014, which was mainly due to the depreciation of the TRY, since FX assets in banks' balance sheets have increased as a result. Still, capital adequacy is well above the legal minimum of 8%, with around 85% of capital classified as Tier-1. While the share of loans in banks' assets amounts to 63%, customer deposits are only 53% of banks' liabilities. The resulting LTD ratio (at an elevated level of 123% at end-2015) makes banks dependent on cross-border wholesale funding (27% of liabilities), and thus, on global financing conditions. Nevertheless, leverage in the Turkish banking sector is low (equity is 11% of total liabilities) and cash reserves remain high (16% of assets). In addition, only 3.1% of total

[61] In case of potential external financing constraints, these funds constitute an important buffer for financial institutions as they even exceed their outstanding stock of short-term external debt.

loans were registered as non-performing at the end of 2015, which together with the banking sector's relatively comfortable capital buffer indicates some leeway to absorb a possible deterioration in asset performance. Loan growth has recently decreased, mainly due to a slowdown in the household sector and among SMEs, while the share of large corporate loans is increasing. The slowdown of credit growth is both supply- (increase in spreads, tightening in credit standards) as well as demand-driven (clients reacting to higher interest rates). While FX credits are not permitted for private households, a potential source of concern is the noteworthy net open foreign currency position of Turkish companies (USD -184 billion in December 2015 or more than 25% of GDP) that makes banks' asset quality vulnerable to lira depreciation. FX lending in the corporate sectors is however mainly concentrated in large corporations (credit larger than 5 million and/or firms with a natural hedge due to FX revenues from exports). Moreover, short-term external liabilities are decreasing thanks to macro-prudential measures by the CBRT favouring long-term external debt (i.e. higher reserve requirements for short-term external funding). Additionally, short-term external debt (remaining maturity up to 12 months) is fully covered by banks' FX reserves held at the CBRT (with the caveat however that there is a risk of further capital outflows and of a decline in FX reserves – see also footnote 6). The CBRT also emphasized that the TRY depreciation was mainly due to portfolio outflows, as foreign investors avoid direct exposures to emerging market currencies, which is in line with the experience in other EMEs. While the availability of banks' borrowing in foreign currency has not been an issue so far, the high LTD ratio still makes banks dependent on global funding conditions, implying some downside risks, particularly in the case of a sudden reversal of capital flows.

Follow-up to the Conclusions of the 2015 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

The 2015 ECOFIN Council conclusions identified a number of areas in need of further policy action by Turkish authorities, including (i) promoting domestic savings, particularly in view of the persistently large current account deficit, and (ii) reinforcing the focus of monetary policy on the pursuit of price stability. Compliance with this targeted policy guidance has been weak. The overly loose monetary policy stance by the CBRT throughout 2015 has led to inflation hovering considerably above target (and even above the upper bound of the uncertainty band of the target) and inflation expectations have continued to be increasingly de-anchored. Furthermore, the CBRT's strategy to tighten implicitly by using instruments other than the main policy rate might undermine its credibility to fight inflation going forward. Additionally, by insufficiently tightening monetary policy, the CBRT also undermined efforts to increase the domestic saving rate and thereby to further narrow the savings-investment gap, which is a prerequisite to sustainably lower external vulnerabilities of the Turkish economy.

3. Assessment

In line with previous years, inflation has overshot the 5% target by a large margin for the whole of 2015, continuing to undermine confidence in the CBRT's commitment to its price stability objective. Moreover, survey-based inflation expectations have recently reached 8.5% for year-end inflation and have persistently stayed close to or above the upper (7%) bound of the ±2% band in recent years, signalling that the CBRT's credibility to meet its 5% target in a sustainable manner might be at risk.

While the CBRT has repeatedly argued that some of the underlying factors are of a temporary nature (such as elevated inflation in food prices), inflation expectations out of line with the target over such an extended period of time may point to fundamental challenges. In particular, the argument of a strong pass-through of the TRY depreciation to higher consumer price inflation, while understandable, is still partly the result of the CBRT's reluctance to increase interest rates despite high inflation expectations (and elevated inflation itself), which may further reinforce depreciation pressures on the TRY. By pursuing a too loose monetary policy stance (and also by failing to give a strong signal to the markets), the CBRT puts risks to macroeconomic and financial stability that are not to be underestimated given Turkey's still sizeable external vulnerabilities. In this context, monetary policy divergence between advanced and emerging market economies may awaken memories to previous episodes of monetary tightening in advanced economies when the TRY came under depreciation pressure. Thus, international reserves should also be boosted, particularly given the improvement in the current account balance, and interventions (and FX sales auctions) should be limited to periods of disorderly market conditions.

Furthermore, the monetary policy framework has remained unnecessarily complex in spite of the publication of a roadmap towards simplification. The usefulness of the unorthodox monetary policy framework that originally aimed at deterring capital inflows has become mostly obsolete and complicates the central bank communication in an environment of portfolio outflows and persistently high inflation rates. Furthermore, the CBRT does not follow its own forward guidance published as a road map in August 2015, which suggested a policy simplification during the normalisation of global monetary policy. While the policy statement in December included some prospects in this direction, including the narrowing of the interest rate corridor, the reference to such measures has been dropped again in the following meetings amidst increased volatility in global financial markets. While the CBRT has opted to maintain money market rates close to the top of its interest rate corridor throughout last year, and also increased the weighted average cost of funding by varying the liquidity offered at its different facilities, an explicit hike of the policy rate may have conveyed a clearer signal to the markets regarding the credibility to fight inflation. Moreover, repeated claims by government representatives to keep interest rates low – particularly before the elections in June and November – might also have played a role, and the impression that the CBRT chooses to implicitly tighten monetary policy by instruments other than the main policy rate could harm the perception of the CBRT's independence in the longer term. The upcoming appointments of five (out of seven) MPC members, including the governor, should be utilised to strengthen the independence of the CBRT.

The insufficiently tight monetary policy stance also jeopardises the achievement of some core objectives highlighted in the government's medium-term programme (MTP). Overly loose monetary policy does not only undermine the price stability objective of the CBRT that is also prominently highlighted in the MTP, but also impedes the increase in domestic savings, and thus, a sustainable closing of the savings-investment gap in Turkey. As high inflation in combination with low real interest rates will not incentivise households to save, monetary policy therefore also impedes a further improvement in the current account and the reduction of external vulnerabilities. Furthermore, to attract foreign direct investment (FDI) as a sustainable source of future current account deficits, it is also key to bring inflation down towards the CBRT's target. Still, some of the burden for meeting these aims clearly falls onto fiscal policy by increasing public savings as well as by launching reforms to address structural rigidities in the economy and to encourage higher private savings, but the role of monetary policy should not be underestimated in this context.

The government has a 4-year window of opportunity to implement structural reforms without facing any major elections. The government's Tenth Development Plan, covering the period 2014-2018, comprises a comprehensive set of 25 Priority Transformation Programs with more than 1200 action points to be implemented aiming at boosting potential growth and reducing external vulnerabilities over the medium term. So far, however, the individual reforms seem to lack clear prioritisation. At year-end 2015, the government has published a shorter plan for the first steps in 2016 which focuses (among other issues) on labour market reforms, increasing the quality of education, reducing the informal sector, and reducing import dependency. Turkey has one of the most inflexible labour markets in the OECD, with limitations on part-time work and high severance pays that give strong incentives to stay in the same company. Besides tackling those weaknesses in the labour market, the government has also proposed a new income tax law which gives tax concessions to newly established businesses under certain circumstances. On top of that, the government has to address the large share of the informal sector, and to make sure that the planned reform steps do not lead to a further increase of the unregistered labour force. Regarding the structurally low savings rate, the government has also proposed a range of measures, including the extension of private pensions to a broader public. Furthermore, the structural reform programme also includes a number of measures to improve the business and investment climate in Turkey, which could potentially also strengthen FDI inflows. A further postponement of necessary reform steps however would make Turkey vulnerable to a sudden-stop scenario against the backdrop of still high external imbalances.

Data appendix

Measures of inflation, interest rates and related indicators

(annual percentage changes unless otherwise stated)

	Albania		Bosnia and Herzegovina		Kosovo		FYR Macedonia		Montenegro		Serbia		Turkey	
	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015	2014	2015
Measures of inflation *(period averages)*														
Harmonised index of consumer prices (HICP)	...	...	...	...	0.4	-0.5	-0.3	0.0	-0.5	1.6	2.3	1.5	8.9	7.7
National consumer price index (CPI)	1.6	1.9	-0.9	-1.0	0.4	-0.5	-0.3	-0.3	-0.7	1.5	2.1	1.4	8.9	7.7
Producer prices	1.4	-2.1	-0.5	0.6	1.7	2.7	-1.2	-3.9	0.2	0.3	0.7	0.2	10.3	10.3
Interest rates *(percentages, annual averages)*														
Short-term policy rate[1)]	2.6	2.0	...	...	...	...	3.3	3.3	...	...	8.8	6.2	8.6	7.6
Medium-term interest rate[2)]	...	5.2	...	...	...	...	3.8	4.2	4.2	4.3	4.0	3.7	...	...
Long-term interest rate[3)]	...	...	...	...	...	...	...	...	...	...	4.8	4.3	3.1	2.4
Lending rate of commercial banks[4)]	7.2	6.3	6.4	5.9	10.6	8.3	6.5	6.1	8.9	7.7	9.8	7.4	11.4	11.7
Deposit rate of commercial banks[4)]	1.7	1.2	2.1	1.7	1.1	0.9	1.0	1.8	2.1	1.5	4.3	3.2	4.3	4.3
Memorandum items:														
ECB main refinancing rate							0.2	0.1						
Euro area long-term interest rate[5)]							1.2	0.5						
Related indicators *(annual percentage changes unless otherwise stated)*														
Real GDP growth *(national sources)*	2.0	2.6	1.1	3.2	1.2	3.8*	3.5	3.7	1.8	3.2	-1.8	0.7	3.0	4.0
Average monthly gross wages[6)]	12.1	8.4	-0.1	0.0	14.2	7.4	1.0	2.7	-0.3	0.3	1.1	0.7	15.5	13.7
Price deflator for imports goods and services	-2.5	-18.7	-1.6	-18.2	-0.4	-0.6	-4.5	-13.5	-4.5	-13.5	-1.6	-17.6	-2.6	-14.1
Real effective exchange rate (CPI-based)	...	...	0.2	-0.8	0.2	-1.8	1.0	-0.2	...	...	-2.2	-5.1	-5.1	-2.7
Money supply (M2)	1.1	3.6	7.5	8.0	...	...	7.3	9.7	...	...	11.9	9.1	17.0	18.0
Private sector credit growth (annual averages), nominal[7)]	0.2	0.4	3.1	0.9	3.8	7.3	8.3	9.1	-2.3	1.6	-2.2	4.9	24.7	21.6
Private sector credit growth (annual averages), real[7)]	-1.4	-1.5	4.0	1.9	3.3	7.9	8.6	9.4	-1.6	0.0	-4.3	3.5	15.9	13.9

Sources: Bloomberg, European Commission (AMECO, February 2016 revision), Haver Analytics, IMF/IFS, IMF/WEO (April 2016 revision), national authorities and ECB staff calculations.

* *ERP estimates.*

Notes:

1) Short-term policy rates cover one-week repo rate (Albania, Serbia and Turkey) and average central bank bill rate (FYR Macedonia). Kosovo and Montenegro are unilaterally euroised. Bosnia and Herzegovina has a currency board.

2) Annual average yield on 5-year government bond denominated in euro.

3) Annual average yield on 10-year government bond denominated in euro.

4) Average, weighted deposit and lending rates applied by commercial banks on new loans and new deposits (outstanding deposits in the case of Montenegro). Simply average for deposit rates in Albania due to lack of currency breakdown). Weighted averages for loan and deposit rates from the two entities in Bosnia and Herzegovina, and weighted averages for Turkey.

5) 10-year generic government bond yield.

6) Annual change in average monthly gross wages, total economy (average monthly paid net wages in the budget sector in euro in the case of Kosovo due to lack of data).

7) Loans to households and non-financial corporations by Deposit Money Banks in Turkey, Other Depository Corporations for all other countries.

Macroeconomic projections

(as a percentage of GDP unless otherwise stated)

	Albania			Bosnia and Herzegovina			Kosovo			FYR Macedonia			Montenegro			Serbia			Turkey		
	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)	2015 (e)	2016 (f)	2017 (f)
Real GDP growth (%)																					
IMF	2.6	3.4	3.8	2.8	3.0	3.2	3.3	3.4	4.3	3.7	3.6	3.6	4.1	4.7	2.5	0.7	1.8	2.3	3.8	3.8	3.4
European Commission	2.7	3.2	3.5	...	...	...	...	...	...	3.3	3.3	3.5	3.9	4.0	4.1	0.8	1.6	2.5	3.1	3.4	3.6
Current account balance																					
IMF	-11.4	-12.7	-12.6	-6.8	-5.8	-5.5	-8.0	-8.3	-8.9	-1.4	-1.7	-2.6	-13.2	-16.5	-17.0	-4.8	-4.4	-4.3	-4.4	-3.6	-4.1
European Commission	-10.9	-11.9	-12.3	...	...	...	...	...	...	0.2	0.2	0.1	-12.9	-13.4	-13.9	-5.1	-4.9	-4.9	-4.8	-4.4	-4.7
General government net lending/borrowing																					
IMF	-4.0	-2.4	-2.5	-1.4	-1.4	-1.2	-1.9	-2.5	-2.4	-3.7	-3.5	-3.3	-7.4	-9.1	-8.9	-3.7	-3.5	-2.6	-1.0	-1.9	-1.3
European Commission	-3.5	-2.3	-1.8	...	...	...	...	...	...	-3.8	-3.5	-3.1	-7.0	-6.6	-6.1	-3.8	-3.7	-3.5	-1.4	-1.7	-1.5
General government gross debt																					
IMF	71.9	70.4	67.8	45.5	45.5	44.5	...	...	...	38.6	38.3	39.7	66.4	70.5	77.0	77.4	78.9	77.9	32.6	30.7	29.2
European Commission	72.3	71.6	69.9	...	...	...	...	...	...	39.6	40.8	41.6	61.4	65.8	68.9	76.2	79.9	81.8	33.2	32.1	31.4
Inflation (CPI change, %, period average)																					
IMF	1.9	1.9	2.5	-1.0	-0.7	1.1	-0.5	0.2	1.5	-0.2	0.5	1.5	1.6	0.9	1.3	1.4	1.7	3.1	7.7	9.8	8.8
European Commission	1.9	2.3	2.6	...	...	...	...	...	...	-0.3	0.7	1.5	1.5	1.9	2.2	1.4	2.4	3.6	7.7	9.0	8.5

Sources: IMF/WEO (April 2016 revision) and European Commission (AMECO, February 2016 revision).

Core financial soundness indicators

	Regulatory Tier-1 capital to RWA	Return on equity	Liquid assets to total assets	NPL to total gross loans	FX loans to total loans	Net open position in FX to capital
Albania						
Dec-13	14.9	6.4	27.6	23.5	63.0	4.1
Dec-14	13.8	10.5	31.9	22.8	62.4	8.5
Dec-15	13.5	13.2	32.3	18.2	60.8	7.7
Bosnia and Herzegovina						
Dec-13	15.2	-1.4	26.4	15.1	62.9	6.7
Dec-14	14.3	5.2	26.8	14.2	62.3	10.2
Dec-15	14.0	3.0	26.4	13.7	61.8	10.2
Kosovo						
Dec-13	12.8	9.5	37.8	8.5	0.1	2.3
Dec-14	14.6	20.7	32.8	8.3	0.3	1.8
Dec-15	16.7	23.7	29.2	6.2	0.3	1.8
FYR Macedonia						
Dec-13	14.4	5.7	27.3	10.9	52.7	15.6
Dec-14	13.7	7.4	25.5	10.8	49.4	17.5
Dec-15	13.9	10.4	24.3	10.3	46.5	11.1
Montenegro						
Dec-13	14.4	0.5	20.0	18.4	3.6	0.3
Dec-14	16.2	5.4	22.2	16.8	3.7	0.4
Dec-15	15.5	-0.7	24.8	13.4	7.9	1.5
Serbia						
Dec-13	19.3	-0.4	38.5	21.4	70.9	4.4
Dec-14	17.6	0.6	37.1	21.5	70.0	3.9
Sep-15	18.8	5.6	35.9	22.0	70.6	4.6
Turkey						
Dec-13	13.0	17.4	47.1	2.6	27.1	-3.5
Dec-14	13.9	14.7	53.7	2.7	27.8	-2.1
Dec-15	13.2	13.6	49.5	3.0	30.8	-0.4

Sources: IMF/IFS, Haver Analytics and national central banks.