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To:	Delegations
Subject:	Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

In view of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey of 12 May 2015, delegations will find attached

"EU Candidate and Potential Candidate Countries' National Economic Reform Programmes 2015: Review and Assessment of Monetary and Exchange Rate Policies"

EUROPEAN CENTRAL BANK

EUROSYSTEM

ECB-RESTRICTED
1 April 2015

EU Candidate and Potential Candidate Countries' National Economic Reform Programmes 2015:

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 2015

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Introduction

This report 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.[1] It is based on the 2015 National Economic Reform Programmes (NERP) prepared by these seven countries, which outline the main economic policy developments and objectives over the medium-term. As of the cut-off date for this report,[2] Iceland had not submitted a NERP report and, in the meantime, has declared that it should not be considered any longer as EU candidate country.

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 though also touching on fiscal policies and financial stability, due to their often sizable 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, outlines recent developments and describes the outlook for policies. 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 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.

2 The data in the report have end-March 2015 as cut-off date.

Overview and key recommendations

Economic performance was very uneven across prospective EU member countries in 2014, with domestic demand being the main engine of growth in most cases. Amid a generally sluggish external environment, this growth divergence is partly explained by a number of idiosyncratic factors such as the effect (or absence) of fiscal consolidation measures, the individual performance of key sectors and the implementation of public investment projects. Relative developments in key trading partners and the exposure to one-off shocks (May 2014 floods) also contributed to increased dispersion in real outcomes. Domestic demand was the key engine of growth in all cases except Turkey, although the split between consumption and investment differed markedly across countries (see Chart 1).

Inflationary pressures have been subdued, especially in countries that use the exchange rate as a nominal anchor (see Chart 2). Inflation in 2014 was weighed down by sharp declines in food and energy prices amid low imported inflation from the euro area. Countries which either peg to the euro or do not have their own separate legal tender saw their headline inflation rates dip into negative territory on an annual basis, while inflation targeting economies experienced positive if below-target inflation. Turkey was an exception to this trend, with inflation remaining above target in 2014.

Fiscal policy execution has been mixed, while public indebtedness has continued to trend up. Actual fiscal deficits in 2014 tended to exceed the objectives initially set by domestic authorities, partly reflecting the incidence of negative external shocks in some cases, and still being an improvement from end-2013 outcomes in other instances. Public indebtedness levels continued to trend-up in all cases except Turkey, albeit at a slower pace than hitherto (see Charts 3 and 4).

Constraints on monetary policy making have been significant in some countries, with fiscal factors adding to external aspects. The pace of policy easing by central banks has been partly conditioned by the extent of fiscal consolidation undertaken by domestic authorities especially in Serbia and, to a lesser extent, in Albania and the former Yugoslav Republic of Macedonia. This has added to the constraints on monetary policy making stemming from liability euroisation in the banking system which, while trending down in many economies in recent years, remains at an elevated level.

Risks to the blurring of the monetary policy signal have persisted and remain high in some cases. Central banks in Turkey, Serbia and the former Yugoslav Republic of Macedonia have continued to partly steer short-term market interest rates through limited liquidity offerings/liquidity absorptions rather than using upward or downward adjustments in their key policy rates as the main policy tool. Although this is also reflective of the influence of external and/or fiscal factors on monetary policy making, a sizeable gap between short-term interest rates and central bank policy rates has remained in these cases in 2014.

External imbalances have remained stubborn. Current account balances in 2014 remained broadly unchanged or widened with respect to end-2013 levels in all cases except Turkey and the former Yugoslav Republic of Macedonia. The reasons behind this trend have been varied across countries, including post-flood reconstruction, increased imports in the context of rising FDI inflows, and a downtrend in secondary income flows, respectively (see Chart 5).

Impairments to the bank lending channel have remained sizeable. In spite of authorities' efforts, the burden on banks from non-performing loans has remained high in all countries except Turkey, and to a lesser extent Kosovo, while credit dynamics have remained sluggish in many cases (see Chart 6).

With the above in mind, the **key recommendations** put forward for prospective EU members in 2015 can be broadly grouped around the following five themes.

First, continue to repair the bank lending channel on account of both potential financial stability and real economy implications. 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 which might become more important in a context of rising credit demand. 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, stepped-up measures by domestic authorities in prospective EU countries in the Western Balkans to help repair the bank lending channel appear warranted, and there is a clear case for such policy action to take place while credit demand remains relatively weak. Notwithstanding sizeable heterogeneity across countries, there are similarities in the broad legal and regulatory factors dampening the non-performing loan disposal process.

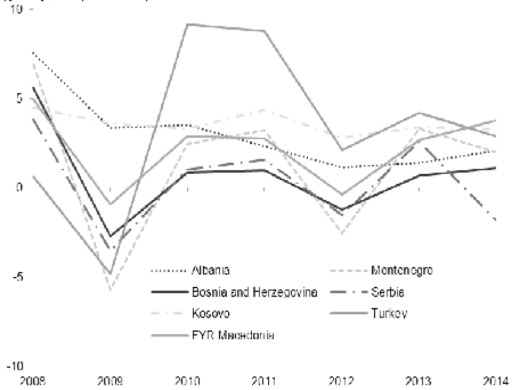
Second, ensure the clear signalling of the monetary policy stance, inter alia to help anchor inflation expectations. The gap between short-term interest rates and key central bank policy rates in Turkey, Serbia and the former Yugoslav Republic of Macedonia blurs the authorities' monetary policy signal. The protracted persistence of this trend would be of particular concern in Turkey and Serbia, in light of the critical role of the key policy rate under the inflation targeting regime in place including helping anchor inflation expectations.

Third, continued progress in reducing the high degree of asset and liability euroisation in the banking system would not only help to fend off potential financial stability risks to banks but also increase the policy degrees of freedom available to monetary authorities. Notwithstanding sizeable variation across countries as regards the share of fx-denominated assets and liabilities in the banking system, this also appears as a broad-based challenge for those prospective EU members in the Western Balkans which have their own separate legal tender. Low and stable inflation amid sustained macroeconomic stability appears as a necessary condition for any successful strategy to increase the role of the domestic currency in the financial system.

Fourth, cement the medium-term orientation of fiscal policy so as to build policy buffers and create room for central banks to act. In countries with high public indebtedness such as Serbia and Albania, the key challenge is to put debt dynamics on a firm downward path, while consideration should be given to developing a credible rules-based framework over the lifetime of the IMF programmes in place. In the former Yugoslav Republic of Macedonia, Montenegro and Kosovo the task is rather to enhance the rules-based fiscal frameworks which already exist, including as regards the development of enforcement mechanisms consistent with the fiscal objectives that authorities have set for themselves in a medium-term context. 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. In turn, this points to the importance of avoiding a procyclical fiscal stance during upswings in growth. Sustained fiscal consolidation would also create room for central banks to (continue to) act should circumstances warrant – a relevant consideration for Serbia, Albania and the former Yugoslav Republic of Macedonia.

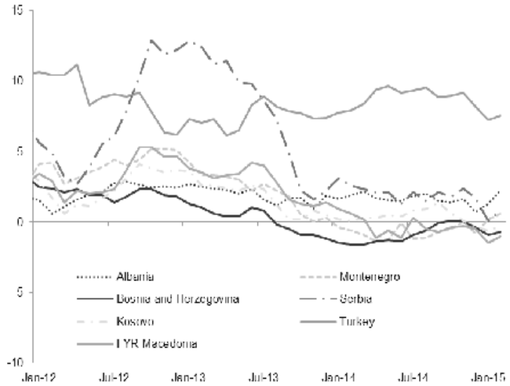
Fifth, continued improvements in the overall business environment should be consistent with both a reduction in external vulnerabilities and a more diversified growth model. External imbalances have been reduced from their pre-crisis peaks but remain high in many cases, pointing to continued competitiveness weaknesses and narrow productive bases and thereby putting a lid on growth. Sustained improvements in the overall business environment should be associated with a reduction in 'structural' trade and current account deficits in the medium-term, 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)



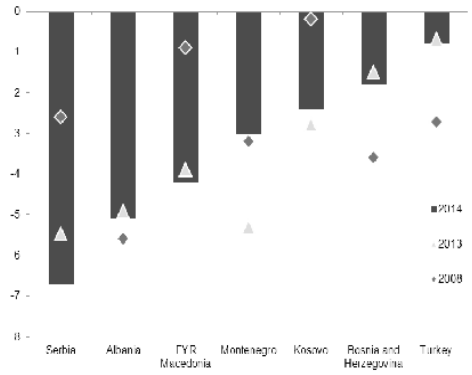
Source: National authorities (figures for 2014 are projections).

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



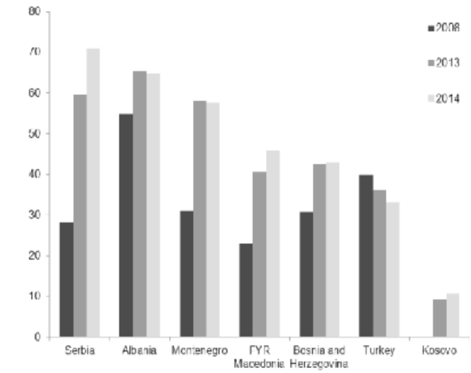
Sources: National authorities, Haver Analytics and ECB staff calculations.

Chart 3. Government net lending/borrowing
(percent of GDP)



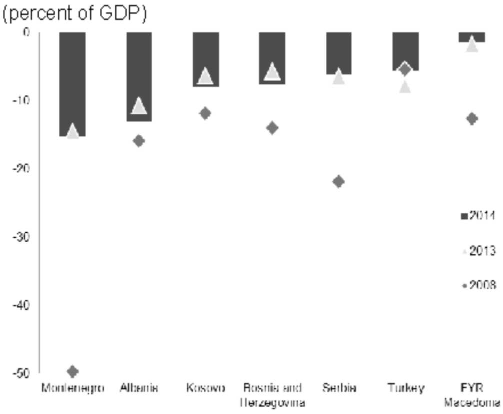
Sources: European Commission, IMF/WEO and national authorities.

Chart 4. Government gross debt
(percent of GDP)



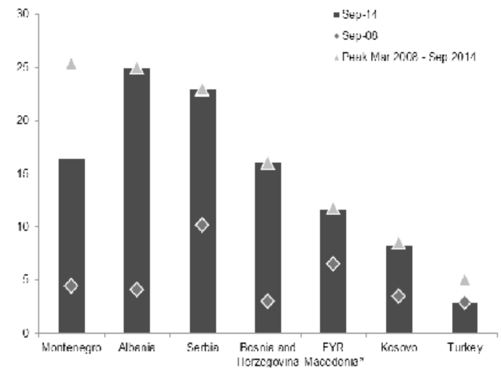
Note: Debt data for Kosovo only available since 2009.
Sources: European Commission, IMF/WEO and national authorities.

Chart 5. Current account balance
(percent of GDP)



Source: IMF/WEO, national authorities and ECB staff calculations.

Chart 6. Non-performing loans to total loans
(in percent)



* Loans to the financial and nonfinancial sector.
Note: Definition of NPLs may differ in between countries.
Sources: National authorities, Haver Analytics and IMF/IFS.

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, aiming to promote sound banking practices and competition within the system, 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 within a tolerance band. The BoA has set the inflation target until end-2016 at the level of 3.0% within a symmetric 1pp tolerance band. 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 are limited and pre-announced and, more importantly, they do not aim to affect the exchange rate path nor prejudice the achievement of the primary objective of the BoA. 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**, serving as a cushion to cope with severe shocks that might hit the real sector of the economy and safeguarding the country's financial stability.

[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.

2. Economic and financial developments

Economic growth, external sector and fiscal developments

An economic recovery is under way, supported by a strengthening of domestic demand. After a protracted slowdown since 2010, the Albanian economy saw a modest growth pick-up in 2014 (see Chart 1). From a supply-side point of view, all the main sectors of the economy provided positive contributions to growth, with services continuing to be a main driver of economic activity and construction and industrial production also showing increased momentum. On the demand side, supported by historically low interest rates and a recent pickup in credit extension private consumption was strengthened, driving much of the observed reacceleration in growth. Net exports, on the contrary, are assessed to have had an overall negative contribution to growth in 2014. For the year as a whole, real GDP is seen to have expanded in a range between 1.5% (EBRD) and 2.1% (NERP and the IMF), with the EC in between (1.7%).

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

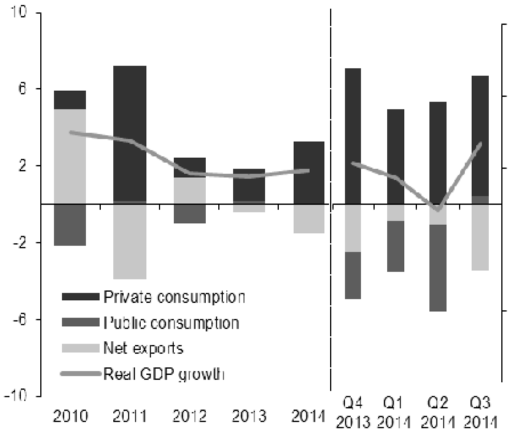
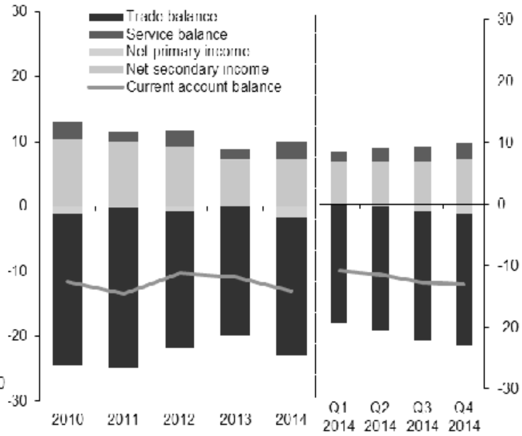


Chart 2. Components of the current account balance
(in percentage of GDP)



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. Private consumption comprises household consumption and gross fixed capital formation. Gross value added for quarterly GDP data.
Sources: Bank of Albania (figures for 2014 are projections), Haver Analytics and ECB staff calculations.

The short- to medium-term outlook is generally favourable for Albania on account of a number of factors. These include higher investment owed to improved EU accession prospects, ambitious structural reforms to boost productivity, a projected economic recovery in main trading partners, the acceleration of large energy-related projects and prospects for a lower burden of non-performing loans (NPLs) on banks' balance sheets. As a result, real GDP growth is expected to accelerate further in 2015 to a level ranging between 2.5% (EBRD) and 3% (national authorities, the EC and the IMF), and to stabilise around 4.4% in the medium-term. Notwithstanding this positive baseline, risks to the outlook appear tilted to the downside mainly on account of the uncertainty about both domestic and external demand. Insufficient fiscal consolidation could undermine confidence and derail medium-term growth prospects.

External imbalances are set to worsen again in 2014. The current account deficit increased to just above 13% of GDP in 2014, from 10.8% of GDP a year earlier (see Chart 2). The expansion of the trade deficit was the main factor behind the deterioration in external imbalances, mostly on account of an increase in domestic absorption associated with the economic recovery, higher weather-related demand for imported electricity and volatile international prices for commodities.[4] A further decline in remittances primarily from the EU – of both a cyclical and a structural nature –[5] also contributed to the deterioration in external imbalances. Looking ahead, the current account deficit is projected to rise further due to higher expected imports of capital goods related to big projects in the energy sector and a still weak export dynamics to the main trade partners in the euro area.

While still financing a sizeable part of the current account deficit, net FDI inflows slightly declined in 2014. This was partly the result of a base effect in view of the large privatization-related inflows in 2013 as well as of higher direct investment abroad in 2014. Although the medium-term outlook for FDIs remains robust due to the expected large investment projects in the energy sector (such as the Trans-Adriatic Pipeline and the Devoll hydropower plant), their narrow base (concentrated on a few sectors) is likely to remain a source of concern, thereby also limiting the room for a broadening of the export base. This underscores both the need to engage in 'investment friendly' structural reforms as well as the importance of maintaining a comfortable foreign reserves cushion for the time being. FX reserves at the central bank stood at EUR 2.2 billion in December 2014 or more than seven months of imports of goods and services, thereby significantly above the four-month minimum targeted by the BoA (see Chart 3).

Fiscal performance under the IMF-supported programme has been better than initially foreseen. The budget deficit for 2014 declined to 5.1% of the projected full-year GDP according to the most recent figures by the Ministry of Finance, thereby undershooting the target of 6.7% of GDP envisaged under the Extended Fund Facility (EFF) programme with the IMF, as agreed in February 2014 (see Chart 4). This over-performance was largely the result of a sharp under-execution of expenditure (both current and capital spending) while revenues were in line with programme objectives on account of the tax hikes implemented throughout 2014 and stepped up efforts to improve

[4] The positive terms-of-trade effect of a lower price for refined oil imports is partly offset by the fact that crude oil is also an important export commodity for Albania, accounting for 31% of merchandise exports.

[5] On the cyclical side, the recession in Italy and Greece has directly affected financial transfers from Albanians living abroad; on the structural side, a large number of emigrants have since returned, thus reducing the remitting population living abroad.

tax collection. The 2014 deficit was only slightly higher than in 2013 (4.9% of GDP), which is remarkable given that the 2014 budget also had to accommodate the repayment of a substantial portion of government arrears to the (private) corporate sector, amounting to 2.4% of GDP.[6]

Chart 3. Exchange rates and foreign exchange reserves

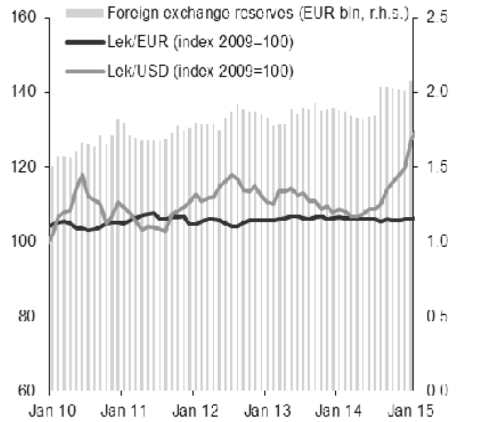
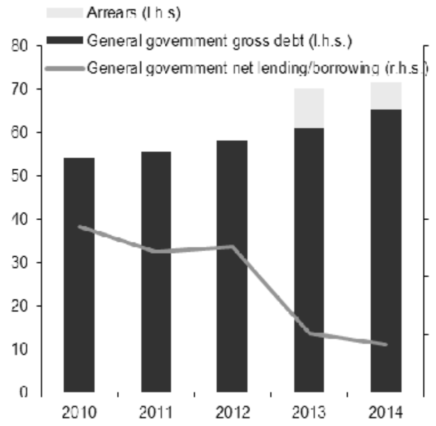


Chart 4. Government gross debt and balance
(in percentage of GDP)



Note: Annual figures for 2014 are projections.
Sources: Bank of Albania, Albanian Ministry of Finance, Haver Analytics and ECB staff calculations.

Authorities are committed to implementing further fiscal consolidation measures in the period ahead. The 2015 budget –consistent with the NERP document baseline – foresees an increase of both excise and fuel taxes, as well as of the tax levied on capital income, amid continued efficiency gains in tax collection. Current expenditures are to be strictly controlled, while capital investment should be maintained at a healthy level of 5% of GDP. Supported by the pension reform (effective as of January 2015) and further progresses in the clearance of arrears to the private sector, the NERP baseline scenario foresees a gradual reduction of the budget deficit to 1.3% of GDP in 2017, from 3.9% in 2015. Moreover, the baseline of both the IMF programme and the authorities' NERP document anticipates that public debt will be put on a steady downward path as of 2015, with the debt-to-GDP ratio falling to 71.6% of GDP from 72.1% in 2014.

Notwithstanding recent policy efforts, putting public finances on a sound footing will remain a challenge, demanding sustained discipline on the side of fiscal authorities. Downside risks to the fiscal baseline are mainly related to a weaker than expected economic recovery, which could dampen government revenues, to fiscal slippages on the expenditure side and to the effectiveness of the anticipated measures to meet the established fiscal objectives. Risks relate, in particular, to the impact of the

[6] Under the Arrears Prevention and Clearance Strategy (APCS), in the second half of 2014 the public sector has started the clearance of the stock of arrears and other unpaid bills towards the (private) corporate sector accumulated since 2005.

crucial energy sector reform,[7] the large stock of unbudgeted investment projects and the size of property compensation claims.

Lingering vulnerabilities stemming from the composition of public debt may also challenge the foreseen fiscal adjustment path. Although average debt maturities have steadily increased in recent years (to 612 days by end-2014 from 559 days in 2013 and 386 days in 2012), almost half of the outstanding stock of public debt still has a short-term nature. Moreover, two thirds of the debt issued domestically by the government (which in turn accounts for 60% of the total public debt stock) is held by local banks. These features clearly render the government vulnerable to rollover risks; as a matter of fact, authorities encountered some difficulties to place the intended amounts of new sovereign debt during auctions conducted in 2014, especially for longer-dated paper, which force them to focus new issuances mostly on the short-end of the yield curve, therefore aggravating existing vulnerabilities. In order to avert similar problems in the period ahead, the government is planning to step up international placements through the issuance of Eurobonds; if successful, this latter strategy is likely to broaden the investor base, reduce the domestic liquidity risks and entail lower overall borrowing costs for authorities, but may come at the expense of higher exchange rate risk and increased vulnerability to changes in external financing conditions. The fact that a larger share of the budget deficit going forward will rely on external sources of funding will also force the BoA to increase its sterilisation of government-related transactions.

Inflation, exchange rates, monetary policy and financial stability

Inflationary pressures have remained low amid a weak overall economic environment. Inflation averaged 1.6% in 2014, down from 1.9% in 2013 (see Chart 5), and thus stood below the lower bound of the BoA's target (3% within a symmetric 1pp tolerance band). The main contributing factors were subdued food prices due to a strong domestic harvest, the fall in international oil prices and the low imported inflation from key trading partners, including in the euro area. Since the BoA's measure of core inflation remained in negative territory throughout most of 2014, low inflationary pressures were also reflective of economic slack.

With inflationary pressures in check and fiscal consolidation underway, the BoA has further eased its monetary policy stance to support the bank lending channel and thereby overall economic activity. In the year to January 2015 the BoA lowered

[7] According to World Bank estimates, the costs accruing to the government for deficiencies in the production, transmission and distribution of electricity accrue to about $100 million per year (0.7% of GDP), in addition to intercompany arrears.

its key policy rate by a cumulative 100 bps to a historic low of 2%. Moreover, it continued to engage in forward guidance in its communication of monetary policy decisions, conditional on demand and supply pressures. Finally, regulatory measures to boost lending and restrict the flow of banking sector investments with non-residents remained in place throughout 2014 and were extended to 2015.[8] Taken together, the available evidence suggests that the BoA's measures have been successful in lowering interest rates as well as to support credit extension more broadly. Lending interest rates applied by commercial banks on both domestic and foreign currency-denominated new loans to private sector borrowers trended down by around 100bps in the year to January 2015, while credit growth accelerated markedly during 2014H2, especially in the Lek-denominated segment (see Chart 6). Risks to the credit outlook appear tilted to the downside especially on account of potential disappointments in economic activity amid lingering challenges to bank asset quality (see below).

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

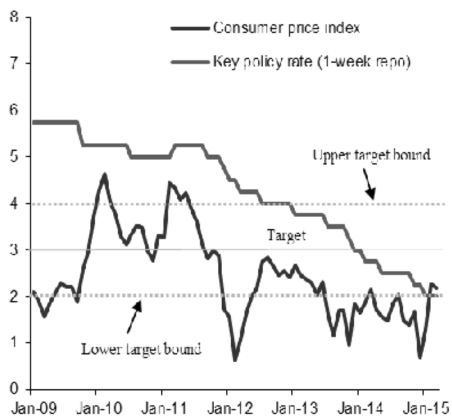
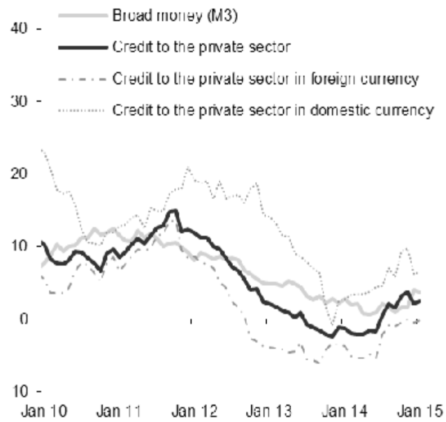


Chart 6. Money and credit growth
(annual percentage change)



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

Going forward, authorities expect inflationary pressures to remain subdued on account of a negative output gap persisting in 2015 amid an uncertain external environment. The BoA expects annual inflation to range between 1.8% and 4.4% four quarters ahead, and to return to the central target of 3% in the medium-term. In 2014Q4 businesses, consumers and financial agents' short-term inflation expectations have continued the downward trajectory in place since end-2012, ranging in the interval 1.5-2% and therefore remaining below the 3% inflation target of the BoA. Risks to the inflation outlook are mostly tilted to the downside and mainly stem from growth potentially disappointing on account of external or domestic factors. This might in turn

[8] The regulatory amendments which were first enacted in March 2013 provide for the removal of capital requirements for the annual growth of lending to the economy if it ranges between 4-10%', as well as for the increase in capital requirements (to 100%) for the additional banking sector investments with non-resident financial institutions.

entail private sector agents' inflations expectations converging to the central BoA target more slowly than currently envisaged. The BoA appears to have some room for further monetary policy easing in such a scenario, notwithstanding its key policy rate standing already at a historical low, and contingent on further fiscal consolidation. However, potential risks related to further interest rate cuts or further non-standard measures should be carefully assessed, especially those related to possibly abrupt exchange rate depreciations in view of wide-spread liability euroisation.

In spite of the authorities' efforts, near-term challenges to bank asset quality on account of high non-performing loan burdens remain sizeable, with potential adverse implications for both financial stability and the real economy. The quality of bank's loan portfolios mildly deteriorated in 2014, with the ratio of NPLs to total gross loans edging up to 24.2% in November 2014 (from 23.5% at end-2013). Developments in the corporate loan segment continue to weigh down heavily on the overall level of NPLs, with the partial liquidation of government arrears providing a weaker impetus to NPLs clean-up than could have been expected ex-ante. Authorities took a number of initiatives as regards NPLs disposal in 2014;[9] while the full impact of such measures has yet to be felt on the ground, commercial banks' perception is that progress in other areas critical to the lending process (such as judicial enforcement and collateral execution) is still needed, thereby helping to reduce the NPLs burden on bank balance sheets in both a direct and indirect manner.

From a financial stability point of view, impaired bank loans will continue to represent a challenge. While the ratio of regulatory capital to risk-weighted assets stood at 17.6% in 2014Q3 (thus well above the minimum required level of 12%) and banks' liquidity position also remained strong (with liquid assets amounting to 32.4% of total assets and 41.2% of short-term liabilities in the same period), NPLs net of provisions to capital still remained high at around 50% in November 2014. This also implies that banks' sensitivity to a less dynamic economic recovery than currently foreseen is higher than would otherwise be the case. From a real economy point of view, the removal of supply-side constraints to credit extension appears to be a necessary condition for a sustained economic recovery. Moreover, the restoration of a fully functioning bank lending channel should also be associated with a more effective

[9] These include changes to the Law on Income Tax by the Parliament (to facilitate the appreciation of loss loans as unrecoverable debt and recognize related provisions as deductible for tax purposes) and measures to facilitate loan restructuring and force write-offs of certain loan categories (in 'loss for more than three years) by the BoA, respectively. The new terms and conditions following the loan modification process aimed at preserving borrower's solvency and loan quality. The loan will continue to be classified as standard but will require higher provisioning of 10%. In order to encourage banks to undertake the loan restructuring process, the regulatory amendments reduced the maintenance of the loan in the same category to six months.

transmission of BoA policy decisions in a context where constraints on policy-making derived from widespread liability euroisation remain high. These factors suggest that NPLs resolution should remain high on the authorities' policy agenda for 2015.

In the medium-term challenges to financial stability continue to stem from indirect market risks to banks, a high exposure to the public sector and the potential for moderate restructuring in the system. The limited net open foreign exchange position in banks' balance sheets suggest limited direct exposure to exchange rate risk, but indirect vulnerabilities derived from lending to unhedged borrowers remain high in a system where foreign currency-denominated loans composed around 60% of total loans (in January 2015). However, the recent dynamism of domestic currency-denominated loans is encouraging, especially on account of the fact that the Lek/Euro lending spread has been significantly reduced. Exposure to potential sovereign shocks remains high with government debt securities accounting for around a quarter of total banking sector assets, although the bulk of these are held on the banking book. Finally, for the banking system as a whole the potential domestic impact of the restructuring process underway in some key parent entities with locally systemic subsidiaries remains uncertain. On the positive side, banks reliance on parent funding remains limited, while risks to the funding base also remain contained on account of a low loan-to-deposit ratio (55% in end-2014).

3. Assessment

Albania weathered the global financial crisis of 2008-2009 relatively well, with macroeconomic and financial stability having been broadly maintained thanks in part to a prudent monetary policy and banking regulatory framework. However, economic growth has been trending down in recent years and significant fiscal vulnerabilities have emerged. Although this trend was partly reversed in 2014, a number of challenges remain going forward.

While recent fiscal developments have been positive, the sustainability of public finances has yet to be cemented, a task which requires enduring policy efforts by domestic authorities. Fiscal performance under the IMF-supported programme has been encouraging, but putting public debt on a sustained downward trajectory will be challenging going forward. In part this is because Albania's growth prospects are contingent on the economic performance in key EU and peer economies. However, downside risks to fiscal consolidation are also home-grown, including potential implementation slippages leading to the re-emergence of arrears, the uncertain impact of the much needed reform in the energy sector, a large stock of unbudgeted investment projects and sizeable contingent liabilities stemming from property compensation claims.

Moreover, vulnerabilities related to the high share of short-term public debt, an excessive reliance on the domestic banking sector for refinancing and plans to increase external debt will continue to pose challenges. In this context, the development of a rules-based fiscal framework which would provide an anchor for the medium-term orientation of fiscal policy beyond the IMF programme would be warranted.

A tighter fiscal policy going forward would also augment the degrees of policy freedom available to the Bank of Albania for the conduct of monetary policy. The maintenance of an accommodative stance in 2014 has been appropriate on account of low headline and core inflation, anchored inflation expectations, a persisting negative output gap and a moderate recovery of bank lending to the private sector. Going forward, headline inflation is foreseen to return to the BoA central target, but the BoA appears to have room for further monetary policy easing should circumstances warrant. However, further easing would be partly contingent on sustained efforts towards fiscal consolidation, consistent with the objectives established in the IMF programme. In addition, potential risks related to further interest rate cuts should be carefully assessed, especially those related to possibly abrupt exchange rate depreciations in view of wide-spread liability euroisation. Overall, while constraints on the conduct of monetary policy stemming from fiscal factors have eased in 2014, they are likely to remain high in the near-term. In this context, increased reliance on external sources of funding to finance the budget deficit will necessitate greater sterilisation of government transactions by the BoA, while the central bank may also be required to lend to the government on exceptional circumstances if the authorities' recourse to domestic and international markets is less successful than currently foreseen.[10] It is thus paramount that the BoA is effectively shielded from direct and indirect risks stemming from fiscal policy, and that no doubts about central bank independence arise, which is of particular importance in view of the developments concerning the BoA in the course of 2014.

Repairing the bank lending channel still appears as a key challenge, on account of its potential implications for both financial stability and the real economy. Various policy initiatives have been taken to boost credit extension and foster NPLs resolution in 2014, but while lending is picking up, progresses as regards the reduction of NPLs burdens on banks' balance sheets has still to be felt on the ground. Addressing impediments such as judicial enforcement and collateral execution with wider implications to foster corporate restructuring would be helpful. While banks' capital buffers remain high NPLs net of provisions to capital also remain sizeable. Moreover, the

[10] See Article 30 of the BoA law.

removal of perceived supply-side bottlenecks to credit extension would be a necessary condition for a sustained economic recovery.

In a medium-term context, reducing the financial stability risks derived from a tight 'sovereign-banking nexus' and high asset and liability euroisation in the banking system appears key. Government debt securities account for around a quarter of total banking assets which, while mostly held to maturity, exposes the banking system to tail risks in the event of adverse sovereign shocks. A reduced reliance on a few players in the domestic banking system to meet funding needs would in turn also render the government less vulnerable to rollover risks, thereby mitigating the increased interest rate and liquidity premia associated with this trend. In addition, a more widespread use of local currency would also help to reduce the possibility of indirect market risks to banks materialising through unhedged borrowers in the event of adverse exchange rate developments. The recent dynamism of local currency- denominated loans – enabled by sustained price stability and a reduction in the lending premium of Lek versus Euro-denominated loans – is encouraging in this regard.

External vulnerabilities will remain sizeable, thus calling for a careful monitoring as well, with a large current account deficit projected to deteriorate further. This is due to higher expected imports of capital goods related to big projects in the energy sector amid still weak export dynamics to the main trading partners in the euro area. As remittances seem to be on a slow but steady decline, the coverage of current account deficits will continue to rely on sustained FDI inflows. In this context, an expansion of the currently narrow base of FDIs would not only mitigate downside risks to external accounts in the near-term, but also allow for a progressive reduction of such imbalances over time through a greater positive contribution from net exports. In turn, thus underscores the importance of sustained implementation of structural reforms to improve the business environment and external competitiveness.

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).[11]

The CBBH operates a strict currency board with no authority to carry out discretionary monetary policy. The monetary policy framework of the CBBH appears to enjoy confidence of the general public 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. 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),[12] but no formal supervisory responsibility.

2. Economic and financial developments

Economic growth, external sector and fiscal developments

The economic recovery underway in early 2014 came to an abrupt halt following severe floods in May 2014. Authorities initially estimated that the floods had caused damages equivalent to nearly 15% of GDP, and thus anticipated a significant decline in real economic activity during 2014H2.[13] However, available data suggests that economic activity has been more resilient than previously thought with real GDP rising by 1.3% q-o-q in December 2014 in seasonally-adjusted terms compared with the 1.0% q-o-q contraction in 2014Q2. Authorities estimate a real GDP expansion of 1.1% for 2014 as a whole, as compared to 2.3% growth in real output projected in the 2014 EFP document

[11] Monetary liabilities refer to currency in circulation, domestic deposits by banks and other residents (Art. 31) 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.

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

[13] See BiH recovery needs assessment: http://ec.europa.eu/enlargement/pdf/press_corner/floods/rna-executive-summary.pdf

(see Chart 1).[14] Looking ahead, authorities expect a robust real GDP growth of 3.4% for 2015, driven primarily by growth in net exports and domestic demand. However, the fact that 2015 real activity forecasts by international institutions vary significantly suggests that there is a high degree of uncertainty as regards growth prospects.[15] Risks to the outlook appear tilted to the downside on account of both domestic and external factors, notably a delay in the resumption of the IMF programme owed to the complex institutional dynamics and a more sluggish recovery in EU and peer economies than currently anticipated.

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

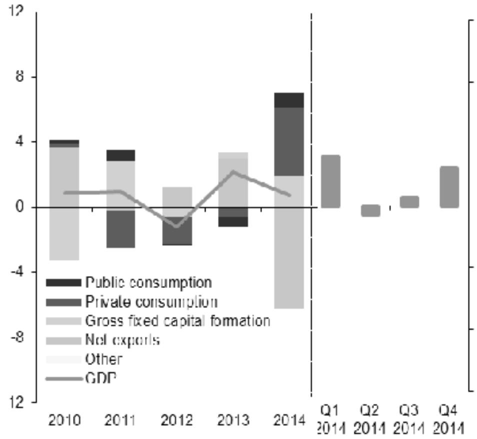
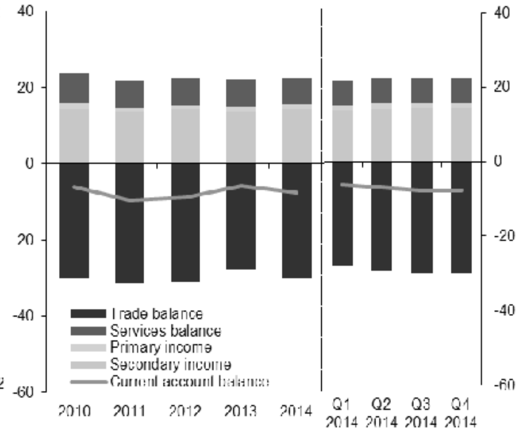


Chart 2. Components of the current account balance
(as a percentage of GDP)



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: Agency of Statistics of Bosnia and Herzegovina, Central Bank of Bosnia and Herzegovina, IMF/WEO (annual figures for 2014 in Chart 1 are projections) and ECB staff calculations.

The current account deficit widened considerably in 2014 in part due to flood-related import needs. In addition, a slower recovery in the main foreign trading partners and the impact of the floods also weighed down on exports. The deterioration in the trade balance was thus the main contributing factor. The current account deficit is estimated to have slightly declined compared with 2013 (to 7.6% of GDP in 2014, see Chart 2) and was partly cushioned by an increase in remittances after the floods.

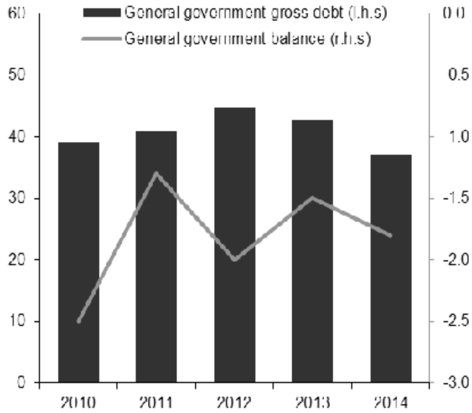
On the financing side, net FDI flows posted a substantial increase in 2014 but still account for a moderate share of the current account deficit and remain low relative to economic size. Net FDI flows increased 18% on a year earlier from January to September 2014, but only made up 2% of GDP (as measured by a four quarter

[14] WEO October 2014 estimates are even more pessimistic, with a real GDP growth of 0.7% in 2014.
[15] The latest projections of the Directorate for Economic Planning (DEP) from January 2015 forecast growth rates of 3.4%, 4.0% and 4.4% in the years 2015-17, respectively. International forecasts for real GDP growth in Bosnia and Herzegovina in 2015 vary widely, ranging from 1.5% (World Bank), 2.7% (EBRD), to 3.5% (IMF). Thus DEP projections appear to be relatively optimistic in comparison.

moving average) and covered only one fourth of the current account deficit. Other investments, predominantly loans from IFIs, have continued to cover a large part of the current account deficit. In addition, the negative trend of net portfolio investment reversed in 2014Q3, recording a net inflow for the first time since 2012Q4.

The fiscal situation deteriorated in 2014 as a consequence of the May floods, thus prompting a fiscal consolidation at the entity level required by increased expenditure and lower revenues. Authorities expect a budget deficit of 1.8% of GDP in 2014 (see Chart 3), broadly in line with the 1.6% of GDP target envisaged in the 2014 EFP, but at odds with IMF WEO projections which projects a general government deficit of 4.2% for 2014.[16] Looking forward, the NERP foresees a slight narrowing of the budget deficit to 1.7% and 1.6% of GDP in 2015 and 2016 respectively. In view of an anticipated robust economic recovery, the general government debt is projected to fall to 27.8% by 2017. However, according to IMF forecasts debt will reach 46.2% of GDP in 2014 fall only to 44.6% in 2016.

Chart 3. Government gross debt and balance
(as share of GDP)



Note: Figures for 2014 are projections.
Sources: European Commission, national authorities and IMF/WEO.

With the IMF programme on hold in the run-up to the October 2014 general elections, entity-level authorities resorted to increased debt issuance on the domestic market to help bridge the financing shortfall.[17] The 8th review of the Fund-supported programme, which was originally envisaged for September 2014, could not be successfully completed due to insufficient progress made as regards several fiscal and structural measures (improving revenue collection, procedural and legal reform in fiscal budgeting). Against this background, entity-level governments increased the issuance of bonds and bills in the domestic market in order to partly compensate for the financing gap. All intended placements were allotted at auction and average primary yields

[16] Major discrepancies between national and IMF projections may partially result from different accounting standards.

[17] A 24-month IMF EUR 390 million Stand-By Agreement was approved in September 2012 and extended by nine months and augmented by EUR 153.1 million in January 2014 to meet additional financing needs. In June 2014 the IMF further augmented the resource envelope of the programme by EUR 95.7 million to help the country cope with the damage caused by the floods. After the two augmentations, the size of the programme reached EUR 632 million, or 330% of Bosnia and Herzegovina's IMF quota.

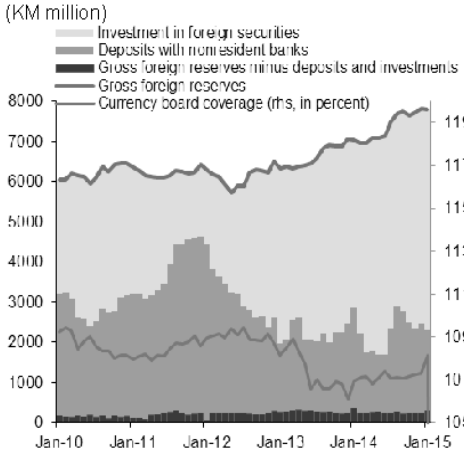
followed a downward path with local banks being the main buyers. However, further pursuing this strategy beyond the very near term is not a viable alternative to the resumption of the Fund-supported programme, both on account of higher financing costs and the large gross financing needs which according to IMF projections will amount to almost 6.8% of GDP in 2015. As a result, protracted delays in multilateral funding appear as a key downside risk to the sustainability of public finances and, through negative confidence effects, also to the broader economic and financial outlook in 2015.

Inflation, exchange rates, monetary policy and financial stability

Inflationary pressures remained subdued in 2014 largely on account of lower food and energy prices, with headline inflation negative for most of the year (see Chart 4). CPI inflation averaged -0.9% for 2014 as a whole and stood at -0.4% at end-2014. Looking ahead, authorities expect a moderate increase in inflation in 2015 and 2016 with annual rates averaging 1.0% and 0.9%, respectively. The main drivers of inflation are expected to be upward adjustments in administered prices, with a foreseen recovery in domestic demand and stronger economic activity in peer countries as well as in the euro area also contributing to this end. Increases in administered prices, notably in electricity sector, envisaged for early 2015 could only have one-off effect.

Chart 4. Consumer price inflation
(annual percentage changes)

Chart 5. Foreign exchange reserves
(KM million)



Sources: Agency of Statistics of Bosnia and Herzegovina, Haver Analytic, Central Bank of Bosnia and Herzegovina and ECB staff calculations.

Downside risks to the inflation outlook appear to stem from the possibility of a more sluggish economic recovery than anticipated in the country and in the EU and peer economies. Developing an inflation expectations survey would help to gauge the potential risks in this regard might also help to anchor inflation expectations in a medium-term context.

The strict currency board arrangement still appears to enjoy a high level of public confidence, serving as an anchor of macroeconomic stability amid a difficult institutional environment. The CBBH has continued to ensure full convertibility of the domestic currency by backing net monetary liabilities with foreign exchange reserves (see Chart 5). Both foreign exchange reserves and monetary liabilities increased in 2014 on account of the disbursements made by the IMF in the context of the Stand-By Arrangement and the significant increase in commercial bank deposits. The currency board's coverage of monetary liabilities thus stood at comfortable levels, reaching 107.3% in November 2014 compared to 106.1% in December 2013. This level corresponds to around 6 months of imports and 27% of (2014 estimated) GDP, respectively, and as such can be deemed as broadly adequate.

The CBBH maintained in 2014 the reserve requirement measures that were introduced in the aftermath of the crisis. Their main objective has been to provide liquidity and stimulate long-term inflows into the local banking sector and thereby support domestic credit extension.[18] Required reserves grew in 2014 in line with the increase in deposits by residents in local currency. The level of central bank reserves continued to be determined by surplus funds (held by banks at the CBBH above the mandatory reserves), with the overall level of reserves rising to EUR 4 billion in 2014 from 3.6 billion in 2013.

The banking sector as a whole exhibits robust capital and liquidity buffers and returned to profitability in 2014, but lingering credit and funding risks remain a matter of concern. In 2014Q4 the capital adequacy ratio (net capital to RWA) reached 16.5% and the liquidity ratio, measured as liquid assets to total assets, stood at 26.7%. The pace of credit extension picked-up relative to 2013 but remained sluggish overall, averaging 3% for 2014 as a whole (see Chart 6). Banks returned to profitability with the return-on-equity ratio reaching 6.5% at end-2014, after being negative in 2013 (-1.4%). The quality of bank's loan portfolios has somewhat improved with the share of non-performing in total loans decreasing to 14.0% at end-2014 (from 15.1% at end-2013). Notwithstanding this improvement, challenges to banks' asset quality remain sizeable and NPLs burdens could rise on account of the direct or indirect exposure of the corporate loan portfolio segment to the fallout from the floods. Many forbearance relief measures introduced by the authorities shortly after the disaster are phased out,[19] and

[18] Between 2008 and 2011, the CBBH introduced differentiated reserve requirements based on maturity and decreased their levels: to 10% and 7% for maturities below and over 1 year, respectively. These measures continue to be implemented by the CBBH.

[19] Approved measures define the possibility of a moratorium on credit obligations and restructuring of loans and include inter alia the extension of the repayment of principal and/or interest, the reduction of the interest rate, and the capitalisation of interest.

the expected economic recovery may be weaker than currently foreseen. Going forward, fostering NPLs resolution should thus remain a priority for domestic authorities, including the implementation of the commitments undertaken as part of the Fund-supported programme. In addition, authorities are working on a banking law amendment, which should become effective in 2015 and would inter alia enable the establishment of asset management companies to facilitate a more efficient management/disposal of banks' nonperforming assets. As regards funding risk, while solid deposit growth amid weak credit demand has contributed to a moderate reduction of the loan-to-deposit ratio,[20] this ratio remained high at 110% in 2014Q3, thus underscoring the banking sector's continued dependency on funding from parent entities.

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

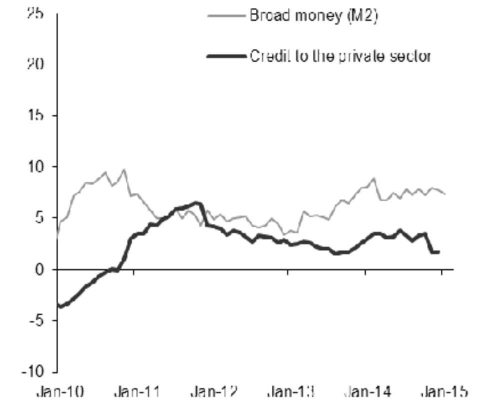
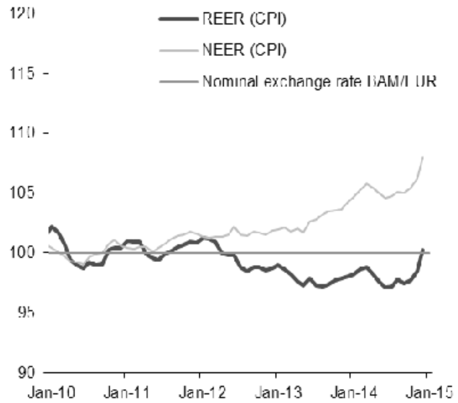


Chart 7. Exchange rate variations
(index 2010=100)



Note: Private sector comprises non-financial corporations and households.
Sources: Central Bank of Bosnia and Herzegovina, Haver Analytics, Thomson Reuters and ECB staff calculations.

In a medium-term context, risks to financial stability stem from banks' vulnerability to indirect market risks in the event that negative 'tail' events were to materialise as regards the exchange rate, due to the high level of fx indexed and fx-denominated loans in the system (which exceeded 60% of the total loan stock at end-2014). Fallout from the recent appreciation of the Swiss Franc appears to have been limited since CHF-indexed loans accounted for only 2% of the total outstanding loans in 2014 and are concentrated in very few entities. In addition, the potential for bank restructuring could add to uncertainty in the system, with the sale of one parent bank still to be formally completed, a number of other parent entities undergoing restructuring, and the recent failure of a domestic bank.

[20] The retail segment continues to drive banking sector credit growth dynamics whereas corporate lending is lagging behind.

3. Assessment

The monetary policy framework of the central bank, a currency board arrangement based on the euro, has continued to provide a stable anchor in a challenging external and domestic environment. The arrangement has continued to secure the full convertibility of the domestic currency and it appears to enjoy a high level of credibility with the general public at large and support of domestic authorities. While under a currency board the capacity of the central bank to influence price developments is very limited, developing analytical tools to better gauge inflation expectations and future price trends would help to better understand potential risks in this regard.

Faced with negative inflation, a fragile economic recovery and sluggish credit dynamics, the central bank has tried to maintain an accommodative stance to the extent possible with the limited tools at its disposal under the currency board arrangement. The central bank continued to apply the lower reserve requirements adopted in the aftermath of the crisis in order to remove potential supply-side constraints to bank lending. The central bank's attempts to this end have yielded moderate results insofar as credit extension has gathered pace in recent months. However, the trend-up in credit growth does not appear to have been thus far associated with a stronger rebound in economic activity.

In order to support this process going forward, other impediments to credit extension that are likely to remain and which lie outside the remit of the central bank should be tackled, including demand-side factors and supply-side limitations related to a relatively high NPLs burden on banks' balance sheets. The measures planned by authorities to foster NPLs resolution, if successfully implemented, are a welcome step in this regard.

The limited degree of policy freedom available to the central bank implies that the main tools for authorities to durably affect economic activity are primarily fiscal and structural policies. By construction, the high degree of credibility associated with a strict currency board such as the one operated in Bosnia and Herzegovina stems from the tight constraints on monetary policy discretion under this arrangement. In this context, fiscal policy thus is the main instrument available to authorities to stabilise economic activity in the short-term, with structural policies providing levers to lift potential growth in the medium-term.

However, structural weaknesses in the economy continue to significantly weigh down on growth, while the fiscal room for manoeuvre is waning. The combination of these factors will likely entail a more protracted economic recovery in Bosnia and Herzegovina than would otherwise be the case. Looking forward, deep structural reforms in labour and product markets as well as improvements in the overall business and institutional environment would help lift growth potential, including through higher FDI inflows. On the fiscal side, the priority is for authorities to regain policy buffers which can be used for short-term stabilisation purposes to safeguard against any potential shocks. Although the Fund-supported programme has improved the fiscal situation, a plan to bring public finances to a sustainable footing in the medium-term (including on the expenditure side) would anchor expectations and support the credibility of an eventual graduation from multilateral support. In turn, this would be important to secure access to international capital markets. Taken together, concerted fiscal and structural measures are not only important to reduce vulnerabilities related to high external imbalances reflecting a relatively narrow export base, but also to secure adequate fx reserve buffers to maintain the currency board arrangement. In the short-term, downside risks to the macroeconomic and financial outlook in case the resumption of the Fund-supported programme is further delayed remain significant.

Given a fragmented institutional set-up, a joint and well-coordinated effort to ensure continued macroeconomic and financial stability is essential. Current efforts by authorities to strengthen the crisis resolution framework are welcome, especially in the absence of a domestic lender-of-last-resort and amid fiscally constrained entities. Further coordination and legislative harmonisation between the two constituent entities of Bosnia and Herzegovina to achieve a uniform economic and regulatory space appear important to foster foreign and domestic investment, competitiveness and hence economic growth.

Kosovo

1. Monetary and exchange rate policy framework

In 2001, the United Nations administration in Kosovo (UNMIK) officially conferred the euro legal tender status in Kosovo,[21] following the adoption of an UNMIK regulation in September 1999 which allowed the use of currencies other than the Yugoslav dinar in Kosovo, with the deutsche mark to be used in budgets,[22] 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.[23] This was followed by a Council declaration in 2007 with respect to Montenegro that acknowledged the exceptional circumstances leading to the euro adoption in Montenegro, but also recalled that unilateral euroisation was not compatible with the EU Treaty. However, it did not lay down a specific solution, stating that *"…the implications of the Treaty framework for Montenegro's monetary regime [would] be detailed in due course, at the latest by the time of possible future negotiations for accession to the EU".*[24] 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.[25] In 2012, the ECB's Governing Council recalled the 2007 Council declaration with respect to Montenegro, 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 (CBRK) 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 CBRK acts as regulator and supervisor of the financial system. Within the

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[21] 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).

[22] 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)

[23] 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.

[24] 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.

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

powers provided by law, the CBRK is independent in accomplishing its main objectives and exercising its duties. Its main monetary policy tool is minimum reserve requirements while it also has a limited lender of last resort function.

2. Economic and financial developments

Economic growth, the external sector and fiscal developments

Amid a slowdown of growth in most peer economies, Kosovo's 2014 real GDP growth remained broadly unchanged with respect to the previous year. According to the authorities' estimates in the 2015 NERP, real growth stood at 3.3% in 2014 after 3.4% in 2013 (see Chart 1). The estimated outcome is below the authorities' projections of 4.2% in their 2013 Medium-Term Expenditure Framework for the period 2014-2016, with economic activity weighed down by a political standstill after the June 2014 general elections, leading to a delay in privatisation and public investment projects. Growth was mainly driven by private consumption, spurred by a 25% increase in public sector wages in the run-up to the general election, as well as by strong remittances.

Looking ahead, economic activity is projected to be strong over the NERP horizon. For 2015, an annual real GDP growth of 4.1% is expected according to the baseline scenario.[26] The main contributor to growth is anticipated to be private consumption, supported by private sector wages seen to catch-up with the 2014 public sector wage increase as well as by continued robust remittances from the main diaspora countries, namely Germany and Switzerland. Also private investments are projected to pick up supported by credit growth and intended government subsidies in certain sectors with export and employment potential (e. g. agriculture and IT services). The NERP's alternative scenario assumes a delayed recovery in the euro area which would negatively affect net FDI and remittances flows to Kosovo and foresees a more moderate real output expansion of 3.3%. The main risks to the outlook stem from the uncertain impact of the massive emigration from Kosovo to the EU in late 2014 and in particular early 2015 when an estimated number of around 20,000 people per month (in a population of about 1.8 million) left the territory, as well as from long-standing structural and institutional weaknesses.

Despite some stabilisation in the trade balance, external imbalances remain high. The current account deficit increased to 8% of GDP in 2014 after a slight improvement in 2013 (see Chart 2). The trade deficit stood at 37.1% of GDP in 2014, mirroring the weak domestic production base, with base metals accounting for half of the economy's

[26] This compares to 3.3% (IMF projection) and 3.0% (World Bank).

exports. Net foreign direct investment has fallen over recent years due to a slowdown in the privatisation process, edging down to 2.2% of GDP in 2014 from 7.9% of GDP in 2011. However, FDIs are expected to increase in the NERP baseline scenario supported by improvements in the business environment and the entering into force of the Stabilisation and Association Agreement (SAA) with the EU which is expected for 2016. A possible new programme with the IMF could serve as an additional stability anchor.

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

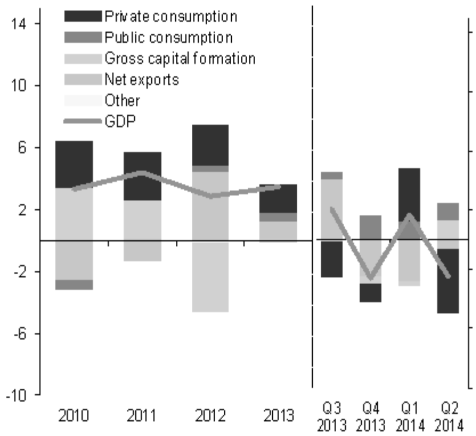
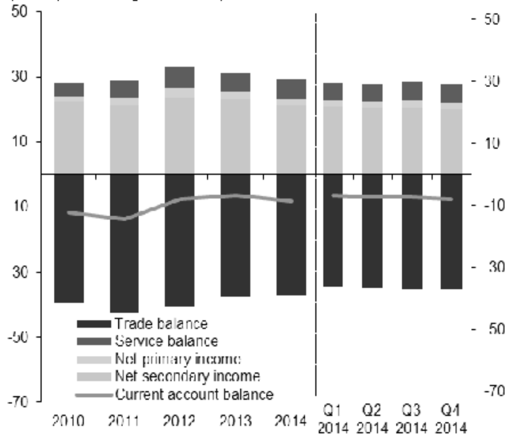


Chart 2. Components of the current account balance
(as a percentage of GDP)



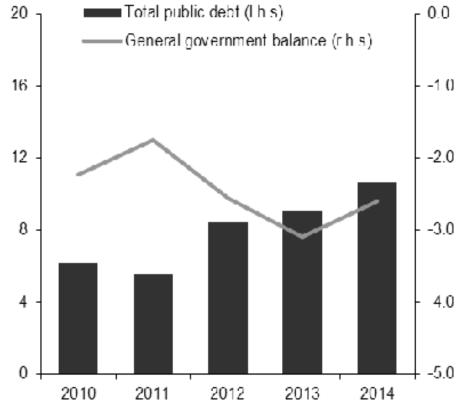
Notes: Quarterly figures for the current account balance are a moving sum of the most recent four quarters. In the case of contributions to real GDP growth, annual growth with respect to the same quarter a year earlier.
Sources: Central Bank of the Republic of Kosovo, Haver Analytics, Kosovo Agency of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

External competitiveness remains a matter of concern. Amid a narrow production base, the authority's monetary and exchange rate policy regime choice implies that improvements in competitiveness can only be achieved through productivity gains or through adjustments in wages and prices, as also acknowledged in the 2015 NERP document. Consequently, the government's strategy includes improving the economy's competitiveness by strengthening the rule of law and further reducing business barriers (e. g. by improving access to finance through better contract enforcement). However, according to the 2015 NERP, competitiveness as measured by unit labour costs decreased in 2014 while the real effective exchange rate has remained stable in recent years. Kosovo's export share has steadily increased within CEFTA which accounted for around 35% of total exports (goods only) in 2013,[27] but not compared to other regions. In that context, Kosovo's jump in the World Bank's 2015 Doing Business ranking from 81st to 75th place (out of 189 countries) is encouraging.

[27] The Central European Free Trade Agreement (CEFTA) consists of Albania, Bosnia and Herzegovina, Kosovo, the former Yugoslav Republic of Macedonia, Moldova, Montenegro and Serbia.

The 2014 budget was the first to be adopted under a new set of binding fiscal rules. The rules foresee nominal ceilings for the annual budget deficit of 2% of GDP – with some exemptions for well-defined events with major fiscal consequences – and for the public debt level of 40% of GDP, respectively. In spite of the sizeable pre-election wage hike for public employees and the lower-than-expected revenues, the fiscal deficit for 2014 is estimated by authorities to have amounted to 2.2% of GDP, on account of savings in other budgetary items (in particular capital spending). The fiscal rule does not foresee any corrective measures as the breach of the deficit ceiling is below 0.5pp of GDP.[28] The public debt-to-GDP ratio stands at 10.6% at end-2014, up from 9% at end-2013 (see Chart 3).

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



Note: Figures for 2014 are projections.
Sources: European Commission, Ministry of Finance of the Republic of Kosovo and ECB staff calculations.

Budget execution is seen to comply with the requirements of the fiscal rule going forward, but implementation risks are high. The planned budget deficit for the years 2015-2017 is anticipated to reach 2% of GDP in every year, thus not leaving any safety margin in case unanticipated fiscal shocks were to materialise (e. g. discretionary spending decisions as experienced in the past) or a worse-than-expected economic performance were to take hold. Moreover, the effects of the 2014 ad hoc rise of public sector wages will continue impacting budgetary processes in the years to come by putting additional pressures on the spending side and reducing the scope for urgently needed capital expenditure. Furthermore, revenue assumptions seem to be on the optimistic side. The government plans to increase revenues, but no concrete measures to this end seem to have been identified as yet. This implies that downside risks to the planned budgetary scenario will remain significant in the period ahead, including in 2015.

Authorities plan to finance the foreseen government deficits mainly by resorting to domestic borrowing,[29] including through the issuance of longer-dated government bonds (with maturities of up to ten years). Expected refinancing needs are high in the years 2016 and 2017 (amounting to around 1% of GDP on average per annum) when repayments to the IMF become due, and the fact that authorities have to largely rely on a (limited) domestic savings pool to meet rollover needs means that risks in this regard

[28] Higher deviations are supposed to be compensated in following years.
[29] As Kosovo does not have a country credit rating, it does not have access to international capital markets.

are larger than would otherwise be the case. The public debt-to-GDP level it is expected to rise further to 14.5% of GDP in 2017.

Inflation, exchange rates, monetary policy and financial stability

Inflation rates in Kosovo are strongly influenced by international price developments on account of both the unilateral euroisation and the high import orientation of the economy. While the average annual CPI inflation rate in 2014 remained in positive territory at 0.4% (down from 1.8% in 2013), the year-on-year rate turned negative in December 2014 (-0.4%) for the first time since November 2009 (see Chart 4). In 2014, there were no changes in minimum reserve requirements. Risks of a deflationary spiral are perceived as low by authorities, in particular given domestic wage dynamics. The authorities' baseline scenario for 2015 foresees an unchanged annual average CPI inflation rate of 0.4%.

Chart 4. Consumer price inflation
(annual percentage changes)

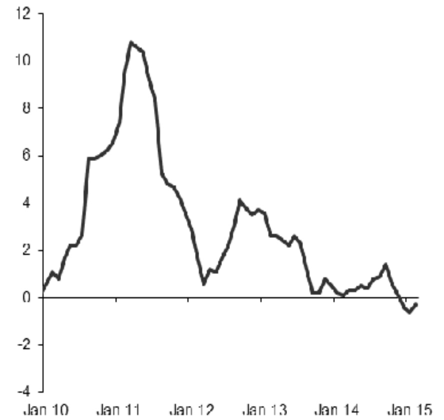
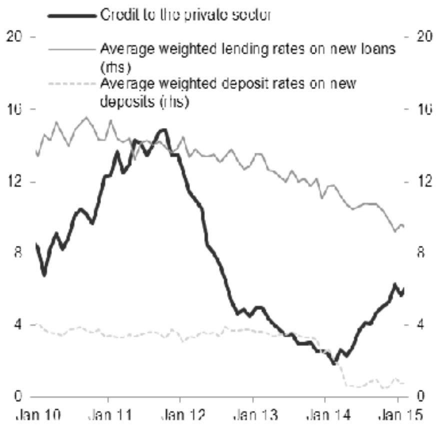


Chart 5. Private sector credit growth
(annual percentage changes)



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.

Kosovo's banking sector remains well capitalised and exhibits ample liquidity buffers, but financial intermediation remains low overall. The banking sector is dominated by foreign banking groups (the largest ones being headquartered in the euro area), which account for 90% of total banking sector assets, and is mainly financed by domestic deposits. The system exhibits robust capital and liquidity buffers with the capital adequacy ratio standing at 18% and the ratio of liquid assets to total assets at 33.4%, respectively (November 2014). Amid a relaxation of lending standards, lending activity has gathered pace in 2014, edging up by 4.2% on a year earlier in December 2014, with the household loan segment showing considerable momentum (up by 12.7% over the same period). In spite of the credit upturn, NPLs have remained broadly unchanged relative to 2013, amounting to 8.6% of total loans in January 2015, and provisioning appears to remain adequate. Kosovar authorities together with the banking sector have established a system of officially licensed private bailiffs to resolve bad debts either in or out of courts which has shown some first positive results. Partly due to increased competition, the average lending interest rate has fallen to single digit levels for the first time in the history of the Kosovar banking system, but lending rates are still high by peer standards (including in real terms) and the spread over deposit rates remains sizeable (see Chart 5). These features in turn partly reflect banks' high credit risk perception, related to wide-ranging informality in the corporate sector and to the legal environment (e. g. contract enforcement, collateral seizure and execution). Overall, the comparatively low level of domestic credit to GDP (34% at end-2014) and the loan-to-deposit ratio of around 74% point to plenty of scope for deeper financial intermediation to benefit the real economy.

In the absence of a traditional lender of last resort function by the central bank, the authorities have established an Emergency Liquidity Assistance fund. The fund is operational, financed by central bank capital and reserves and a government deposit, while commercial banks have been asked to provide "letters of comfort" from their parent institutions that these would provide liquidity to the fund in case of need. The intended overall volume of the fund is around EUR 200 million (or about 6½% of total banking sector assets).

3. Assessment

Kosovo's monetary and exchange rate policy regime choice severely constrains the policy degrees of freedom, thus putting a higher onus on sound policy execution in other areas, in particular fiscal and structural policies. In this context, further progress needs to be made in order to increase the competitiveness of the Kosovar economy as well as to diversify the sources of growth for sustainable development, a process which should be associated with a reduction in external imbalances. Improvements in the overall business environment, the legal framework and law enforcement appear particularly important in this regard, as also acknowledged in the NERP. The current growth model based on externally financed domestic consumption may not only prove to be unsustainable over the medium to long run but is also subject to short-term risks in case of a fading out of capital inflows.

A credible track record needs to be established under the rules-based fiscal framework. The transparency, predictability, and credibility of fiscal policy were hampered by the sizeable discretionary public sector wage hike of 2014. This was particularly unfortunate insofar as the 2014 budget had been the first to be adopted under the new set of binding rules. The impact of this decision will continue to be felt in future budgetary processes, especially by shifting the spending pattern towards less productive and growth-enhancing expenditure items and thereby weighing on the quality of public finances and implicitly putting more pressure on revenues to bridge any potential shortfalls. Furthermore, in light of the fiscal baseline submitted by authorities in the NERP document, it seems that the 2% of GDP fiscal deficit threshold is implicitly seen as an operational target rather than a maximum ceiling. A more cautious medium-term budgetary planning would provide authorities with room for manoeuvre in case of adverse shocks to the economy.

The fiscal framework needs to be complemented by a stronger enforcement framework, in particular as regards corrective measures. While low, the public debt-to-GDP level needs to be monitored carefully. Given the environment of very low inflation rates, the central bank should thoroughly assess price developments. The establishment of a reliable measure of private sector inflation expectations would be helpful in that regard.

Financial stability has been preserved but improvements in the legal environment could help intermediation. The banking sector displays robust capital and liquidity positions and challenges related to bank asset quality (non-performing loans) appear to remain contained. However, despite lending standards being relaxed recently, the corporate sector reports obstacles in its access to finance as a considerable limitation to doing business. Further progress in strengthening the rule of law could help deepening financial intermediation, which remains low by peer economy standards. The intended extension of maturities of government debt through longer-dated issuances over the coming years is a further step to develop local capital markets.

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 achieve its ultimate objective, the NBRM uses the level of the exchange rate as an intermediate objective of monetary policy. The NBRM has anchored its exchange rate through a *de facto* fixed exchange rate since 1995, initially to the Deutsche Mark and subsequently to the euro as of 2002. The IMF's Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER) reports that the de jure exchange rate arrangement for the FYR of Macedonia is a floating arrangement. However, the de facto exchange rate arrangement 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, as well as the NBRM's need to establish credibility 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. Other domestic instruments include repo transactions, outright purchase and sale of securities on the secondary market, and fine-tuning operations.

2. Economic and financial developments

Economic growth, fiscal developments and the external sector

The pace of economic activity gathered momentum in 2014, driven by robust domestic demand. Looking at GDP by expenditure components, the orientation of growth thus changed with respect to 2013, when net exports provided significant impetus to overall economic activity (see Chart 1). The strength of domestic demand was mostly attributable to large public infrastructure projects and solid FDI inflows on the investment side, with a recovery in private consumption against rising wage growth providing additional support. Overall, real GDP expanded by 3.8% in 2014 as a whole, up from 2.7% in 2013. This outcome thus compares favourably to the 3.2% real GDP expansion envisaged in the authorities' PEP document for 2014.

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

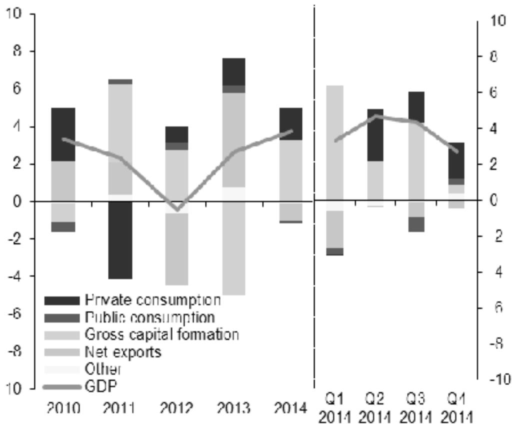
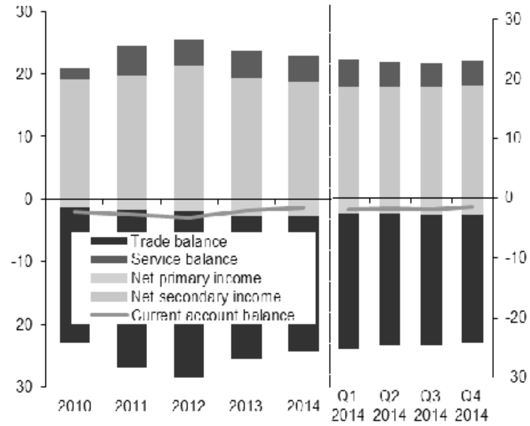


Chart 2. Components of the current account balance
(as a percentage of GDP)



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: State Statistical Office of the Republic of Macedonia, National Bank of the Republic of Macedonia and ECB staff calculations.

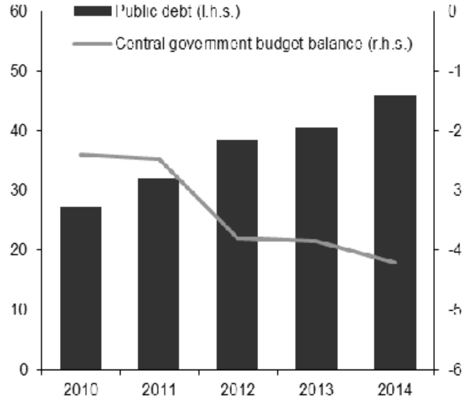
Real growth is anticipated to accelerate further in a medium-term context, with overall activity remaining heavily dependent on consumption and investment. The NERP document foresees real GDP growth edging up to 4% and 4.2% in 2015 and 2016 respectively, with domestic demand remaining the only driver of growth and net exports continuing to weigh down on economic activity, albeit at a slower pace than hitherto. [30] The authorities' sanguine outlook contrasts with that of other institutional stakeholders which, while still robust, appears slightly less bullish in comparison.[31] Risks to this favourable outlook appear tilted towards the downside and include a more protracted recovery than currently envisaged in EU and peer economies, which might compromise as well as the authorities' favourable scenario for future FDI inflows, a less vigorous implementation of public infrastructure projects than foreseen at present as well as a potential overestimation of the positive spillovers stemming from both large public works (if fully realised) and activity in the free economic zones.

Budgetary execution slipped again in 2014, while the pace of fiscal consolidation going forward has been eased notwithstanding an expected positive output gap. In spite of the fact that real GDP growth surprised on the upside in 2014, budgetary execution slipped, with authorities resorting to a supplementary budget in order to bridge

[30] The NBRM expects real GDP to rise by 4.1% and 4.5% in 2015 and 2016 respectively.
[31] In this regard, the IMF foresees a real GDP expansion of 3.7% and 3.9% in 2015 and 2016 respectively, while the EC anticipates real growth to rise by 3.5% and 3.6% over the same period. For more information, please see the IMF's Staff Report for the Fourth Post-Program Monitoring Discussions (released January 2015) and the EC's Winter 2015 Forecast (released February 2015).

the expected shortfall.[32] While the revised baseline as amended in September 2014 allowed for the end-year deficit to expand to 3.9% of GDP, authorities estimated a more moderate outcome of 3.7% of GDP in their NERP document, but the end-year outcome still surprised on the negative side at 4.2% of GDP. This constituted a slippage of 0.7pp relative to the budget deficit target envisaged in the 2014 PEP document. Going forward, the NERP document outlines a more modest fiscal adjustment path than previously envisaged, with the expected budget deficit edging down to 3.3% and 3.2% of GDP in 2015 and 2016 respectively, as compared to the 3.2% and 2.6% of GDP targets outlined in the 2014 PEP document for the corresponding years.[33] The authorities' revised fiscal baseline also implies that the budget deficit is not seen to converge to just under the 3% of GDP threshold until 2017, when the constitutional deficit and debt ceilings (of 3% and 60% of GDP respectively, which have yet to be approved by parliament) are expected to become binding.

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



Sources: National authorities.

A tighter fiscal stance going forward would thus offer authorities some room for manoeuvre to help accommodate unanticipated shocks. Overall, the medium-term fiscal stance can be seen as procyclical since, as acknowledged in the NERP document, a progressive deterioration in both the primary and total structural budget balance is foreseen over 2015-2017 notwithstanding the fact that the output gap is expected to remain positive for the bulk of this period.

Debt dynamics have become more favourable, but public indebtedness has yet to be put on a downward path. Public debt increased to 45.8% of GDP in 2014,[34] up from 40.5% of GDP in 2013 and including a sizeable (7.7% of GDP) component of government guaranteed debt (see Chart 3). Authorities' debt management strategy has led to tangible improvements insofar as a lengthening of average debt maturities and an increase in the share of fixed rate debt are concerned, implying reduced rollover and

[32] On the expenditure side, this was largely to accommodate higher spending in one of the on-going highway projects ('corridor 10').

[33] The real growth baseline outlined in the NERP 2015 document is broadly comparable to that envisaged in the 2014 PEP document, with a stronger real output expansion now foreseen in 2015 (up by 0.2pp relative to the PEP forecast) mostly compensating for weaker 2016 activity than previously envisaged (down by 0.3pp relative to the PEP forecast).

[34] Part of this increase is explained by the government's EUR 500mn eurobond issuance of July 2014 which was inter alia designed to help pre-fund expected financing needs in 2015.

interest rate risks respectively, while coming at the expense of increased exchange rate risk (including through international debt issuances). Insofar as the external component is expected to continue to account for the bulk of the total public debt stock (63% of the total in 2014Q3), this implies that the potential sensitivity to sudden shifts in external financing conditions will remain high. Overall, the NERP baseline anticipates a broad stabilisation of rather than a reduction in public indebtedness in a medium-term context, where total public sector debt is not seen to exceed the 50% of GDP mark in the 2015-2017 period.

In spite of improved export performance, developments in external balances are likely to remain challenging in the period ahead. Export growth was robust in 2014, which in spite of the high import content of a dynamic investment cycle led to a reduction in the trade deficit for goods and services (of 1pp, to 17.5% of GDP) relative to 2013. Notwithstanding a modest decline in secondary income flows, this contributed in turn to a narrowing of the current account deficit to 1.3% of GDP in 2014, significantly below the 2.7% of GDP end-year estimate which authorities outlined in the NERP and also down from 1.8% of GDP in 2013 (see Chart 2). However, looking ahead, the NERP document baseline foresees a broadly stabilised or mildly declining trade deficit over 2015-2017 amid a slow but steady downtrend in secondary income flows (mostly workers' remittances). As a result, the current account deficit is seen to further widen to 3.9% and 4.6% of GDP in 2015 and 2016 respectively before edging down to 4.1% of GDP in 2017. This also implies that the importance of FDIs to compensate for the envisaged shortfall in remittances and thereby help keep external balances in check will be higher than hitherto.[35]

Risks to the authorities' external account baseline thus appear tilted towards the downside, and include a more pronounced downturn in remittances than currently anticipated, less robust FDI inflows than expected and (relatedly) more limited positive spillovers from the latter on export performance going forward, respectively. External competitiveness indicators do not appear to give significant cause for immediate concern, although the maintenance of some of the identified trends for a protracted period of time would be troublesome.[36] Lingering challenges on the external balances front will continue to underline the need to maintain a comfortable fx reserve cushion, including to buttress the stability of the peg to the euro. In this regard, the reserve-to-

[35] The foreseen dynamism of FDIs (with authorities expecting an increase in net FDI flows to 4.2% of GDP in 2017, from 3.6% of GDP in 2014) is also likely to continue to impinge of the economy's net international investment position. As acknowledged in the NERP document, this is well below the lower bound of the 'safe' threshold established in the EU's Macroeconomic Imbalances Procedure.

[36] As acknowledged in the NERP document, progress in the country's share in world exports has remained lacklustre in recent years and nominal unit labour costs have been mildly trending up, but estimates on the equilibrium real effective exchange rate do not point towards major misalignments being in place

import ratio stood at 4.3 months in end-2014, which may be seen as adequate buffer, but public debt in foreign currency is estimated to have slightly exceeded central bank reserves in end-2014.[37]

Inflation, exchange rates, monetary policy and financial stability

Inflationary pressures have remained subdued in 2014 on account of external factors Inflation was on a downward trend in 2014 dampened by lower food prices and generally weak imported inflation, with the CPI index averaging a negative growth rate of 0.1% for the year as a whole (see Chart 4). While headline inflation has been posting negative rates of annual growth since April 2014 and showed no signs of a trend reversal into 2015 (declining by 1.2% on a year earlier in January), core inflation has also dipped into negative territory in recent months, thereby suggesting that disinflationary pressures remain broad-based. Looking ahead, the NERP document foresees inflation to average 1% in 2015 as a whole, consistent with the central bank's own projections. However, the central bank's inflation expectations survey corresponding to October 2014 revealed that most agents expected an average inflation rate of only 0.3% in annual terms for the 12-month period ahead. This marked a significant downtrend in private agents' inflation expectations one year ahead relative to the June survey, when most respondents expected an average inflation rate of 1% going forward. The 'gap' between official and private sector inflation expectations thus suggests that risks to the authorities' inflation baseline are tilted towards the downside, in line with the nature of the risks identified for overall economic activity. In a medium-term context, the NERP document foresees inflation progressively edging up to 2% in 2016 and 2017, as the estimated output gap in the economy becomes positive.

The central bank maintained an accommodative policy stance in 2014 in a bid to support the bank lending channel, with further policy easing contingent on external and domestic fiscal developments. The NBRM left its key policy interest rate unchanged at its historic low of 3.25% throughout 2014 and extended the period of application of the non-standard monetary policy measures in order to boost lending in certain economic sectors. The central bank continued to apply its differential reserve requirement policy (on domestic and fx liabilities) while tightly managing the nominal exchange rate within a narrow band, engaging in net fx sales of EUR 5.4 million in 2014 as a whole (see Chart 5). In addition, the central bank continued its limited absorption of banks' liquidity surpluses, a policy which began in July 2013 through fixed price auctions

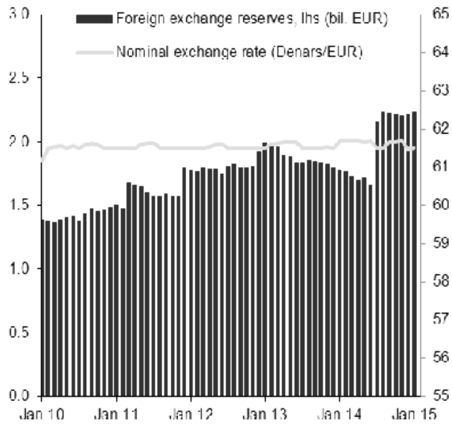
[37] See the IMF's Staff Report for the Fourth Post-Program Monitoring Discussions with the former Yugoslav Republic of Macedonia, dated 27 January 2015.

and limits on central bank bill issuances. However, commercial banks responded to this by making increased use of the NBRM's seven-day deposit facility, which in turn partly reflects the fact that yields on short-term government debt securities are below central bank policy rates. The protracted 'abuse' of the seven-day deposit facility to mop up banks' structural liquidity surpluses (rather than to manage short-term liquidity fluctuations, as originally intended) risks blurring the monetary policy signal.

Chart 4. Consumer price inflation

(contribution to annual percentage change in CPI)

Chart 5. Foreign exchange reserves



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

The central bank's measures have been associated with a pick-up in the pace of bank lending in 2014, with credit growth to the private sector accelerating to just under double-digit levels amid a general downtrend in the cost of credit, especially in the denar-denominated segment (see Charts 6 and 7). In a context where credit dynamics remain robust, economic activity is expected to accelerate, and other indicators (e.g. wages, employment) do not point to the presence of significant economic slack in the economy, the case for further monetary accommodation by the central bank going forward remains questionable. Should external circumstances warrant, the NBRM could entertain the possibility of further 'conventional' policy easing, while remaining mindful that a certain positive spread with the ECB key policy rate is needed in order to support the peg to the euro. However, this would appear to be contingent on authorities embarking on a more ambitious fiscal adjustment path than presently foreseen, with a tighter fiscal stance helping to instil confidence on the value of holding denar-denominated assets and thereby creating room for the central bank to act. Pending such a move, the central bank will continue to be on the receiving side of other decisions taken by fiscal authorities, including the need to step-up sterilisation efforts stemming from the way in which the budget deficit will be financed de facto going forward (i.e. by tapping external sources of finance). Overall, as anticipated in the 2014 PEP assessment, fiscal factors put an undue burden on the conduct of monetary policy.

The banking system has remained resilient, but lingering challenges to asset quality are still of concern. The banking system remained robust in 2014, with regulatory (Tier-1) capital to risk-weighted assets standing at 13.7% in 2014Q4 (down 0.7pp from the end-2013 reading but still and well-above the regulatory minimum set by domestic supervisory authorities), liquidity buffers remaining ample, and profitability trending up. However, in spite of the acceleration in credit growth, non-performing loan burdens on bank balance sheets have remained stubborn, with the ratio of NPLs to gross loans standing at 11.3% in end-2014, from 11.5% a year earlier. Although provisioning remains healthy for the system as a whole and NPLs are fully covered, banks still appear as rather reluctant to write-off claims.

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

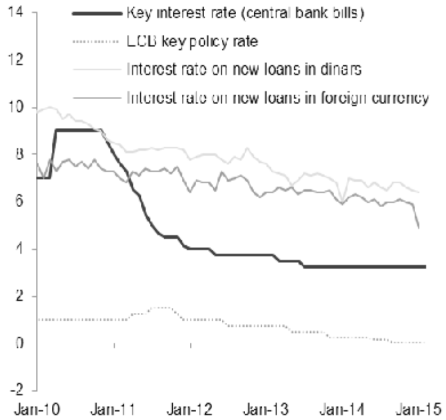
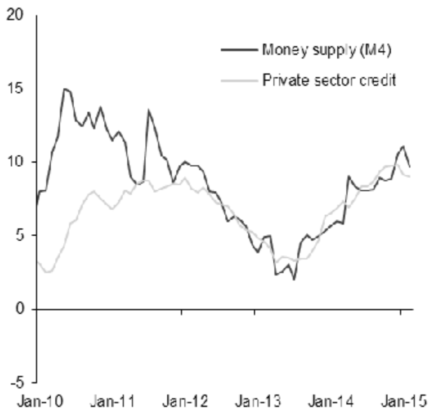


Chart 7. Money and credit growth
(annual percentage changes)



Notes: Key interest rate for FYR Macedonia refers to the 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.

Credit risks through lingering challenges to asset quality and their potential effect on bank profitability thus remain the main short-term risk to financial stability, as well as a potential drag on the real economy through the bank lending channel and thus an obstacle to the efficient transmission of monetary policy. Authorities have taken a number of steps to foster NPLs resolution in recent years, including through new credit risk management regulations by the NBRM which inter alia provide for the mandatory write-off of foreclosed assets. While such measures appear to have gained some traction on the ground, banks still report a number of weaknesses surrounding the NPLs disposal process, including as regards enforcement mechanisms and procedures relating to corporate restructuring and insolvency. Taken together, this suggests that NPLs resolution should remain a priority in the authorities' policy agenda for 2015.

In the medium-term, the banking system's indirect vulnerability through unhedged borrowers in the event of adverse exchange rate developments remains large,

constituting a tail risk to the outlook. In this context, the share of loans denominated in or indexed to fx in total loans has continued on a downward path, edging down to 50.5% in 2014Q3 from 53.5% a year earlier, with a lower interest rate spread on new denar versus fx loans contributing to positive credit dynamics in the local currency. Similar trends can be observed on the side of banks liabilities (deposits). In addition, although the relative dependency on external (parent) funding by domestic banks is low and entities are mostly reliant on local deposits for funding, the potential impact of the restructuring of key parent entities remains uncertain, in a context where banking concentration remains high.

Follow-up to the Conclusions of the 2014 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

The 2014 ECOFIN Council conclusions identified a number of areas for further policy action by the authorities of the former Yugoslav Republic of Macedonia, including the implementation of a medium-term fiscal strategy and measures to clean-up non-performing loan portfolios and promote the use of the domestic currency in the financial system, respectively. Implementation of this targeted policy advice has been varying. Authorities' proposed the introduction of debt and deficit targets, but these have yet to be approved by parliament and corrective/enforcement measures have yet to be developed. Concerning the financial system, the authorities do not report taking any new measures towards NPLs resolution in 2014, although some of the measures taken in 2013 (such as the forced recognition of progressive impairments on foreclosed assets) had an inherent time-varying element. The maintenance of low and stable inflation by the NBRM is seen to have contributed to the increased denarisation of the banking system, with comparatively high rates on denar deposits and an accommodative monetary policy stance helping to reduce the spread of denar versus fx loans.

3. Assessment

Economic performance in the former Yugoslav Republic of Macedonia improved in 2014, with growth dynamics driven by strong domestic demand amid a notable contribution from the public sector (through infrastructure projects) to this end. The exchange rate-based monetary policy framework pursued by the central bank has continued to provide a stable external anchor for price and macroeconomic stability and, within the constraints inherent in such a framework, the maintenance of an accommodative policy stance by the central bank has helped to lift credit dynamics. Inflation expectations appear to remain anchored. However, notwithstanding these positive traits, a number of challenges can be identified for the period ahead.

Economic activity is set to remain heavily dependent on the continued vigour of domestic demand, with sizeable risks to the outlook should this engine of growth disappoint. Authorities are pursuing a dual growth strategy based on public infrastructure building and overall increases to the economy's total capital stock (through FDIs attraction) from which they expect to reap sizeable benefits in the medium- to long-term. Notwithstanding the merits of this approach, growth performance going forward looks to be excessively skewed towards domestic demand, such that the downside risks should this engine of growth disappoint (due to external or domestic factors) are higher than would be the case under a more balanced approach.

The medium-term orientation of fiscal policy has yet to be cemented. According to the authorities' own estimations, fiscal policy will be pro-cyclical in 2016 and 2017, at a time when the output gap is foreseen to be positive. Moreover, the revised fiscal consolidation path implies that authorities will have few policy buffers to accommodate potential unanticipated shocks on the way to reaching a 3% of GDP budget deficit target in 2017, at a time when foreseen ceilings on fiscal debt and deficits are scheduled to become binding. While the latter objectives are a welcome step to increase the predictability of fiscal policy, these still have to be approved by parliament and corrective/enforcement mechanisms have yet to be developed. Overall, fiscal consolidation in good times and enhancing the medium-term orientation of fiscal policy is not only important in its own right, but especially given the fact that it is the main tool available to authorities for short-term stabilisation purposes. With the absence of the use of the exchange rate as a shock absorber, the bulk of the effort to support economic adjustment and keep real exchange rate appreciation pressures in check will continue to fall on structural reforms and fiscal policy, respectively.

The rising influence of fiscal factors puts an undue burden on monetary policy making. The NBRM has been on the receiving side of a number of developments in the fiscal realm in 2014. These have included increased use by banks of the central bank's seven-day deposit facility in the face of low-yielding short-term government securities and the maintenance of a policy stance which, while accommodative, could have been even more supportive had a more balanced policy mix been in place. Going forward, the government's increased reliance on external sources of funding to finance budget deficits will force the central bank to sterilise the net influx from government transactions in order to support the peg to the euro. A more ambitious fiscal consolidation strategy by authorities than currently foreseen would offer some degree of policy freedom for the central bank to act should external circumstances warrant. Overall, as anticipated in the 2014 PEP assessment, fiscal factors are now putting an undue burden on monetary policy making.

The restoration of the bank lending channel deserves continued attention. The central bank's attempts to revive potential supply-side constraints to the bank lending channel through standard and non-standard measures have been associated with a pick-up in credit dynamics and a reduction in the cost of credit in 2014. However, the burden on banks' balance sheets from non-performing loans has remained high. In spite of ample provisioning, lingering challenges to asset quality pose a potential near term risk to financial stability through bank profitability. In addition, the implications stemming from an impaired bank lending channel for the real economy as well as for the efficiency of monetary policy are potentially far-reaching. While a number of steps have been taken in recent years, this implies that efforts towards NPLs resolution should remain a priority in the authorities' policy agenda for 2015.

External vulnerabilities remain sizeable notwithstanding improved export performance. The economy remains dependent on net current transfers and FDIs to rein-in structural trade deficits. However, secondary income flows are foreseen to slowly but steadily decline in the period ahead, thus putting the onus on the anticipated improvement of foreign investment to keep external vulnerabilities in check. While export performance has been surprising on the upside, external imbalances are set to widen in the near-term as a result of public infrastructure and FDIs projects, and the favourable impact of such variables on external accounts, exports structure and real growth will only be felt in the medium-term. Developments on external balances also have a particular bearing on the conduct of monetary policy given the need to maintain adequate reserve buffers to ensure the continued credibility of the de facto peg to the euro.

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.[38] 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".[39] Differently from what was the case in the 2014 PEP, the authorities do not make any reference to this issue in this year's document. 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.[40] In 2012, the ECB's Governing Council recalled the 2007 Council declaration, indicating that all options would remain on the table.

In the context of unilateral euroisation, the scope for discretionary 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 macroprudential 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, though following a revision of the central bank law, it has some kind of lender of last resort function for which it could use its capital, the minimum reserve requirements held at the CBCG by the bank in question and its own capacity to borrow on the market.

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[38] 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.

[39] 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.

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

2. Economic and financial developments

Economic growth, the external sector and fiscal developments

Economic activity slowed down in 2014 compared to the previous year. The real GDP growth rate fell from 3.3% in 2013 to 2.0% in 2014, as estimated by the authorities in the NERP. This is well below the 3.6% expansion in real output that was detailed in the authorities' 2014 PEP baseline scenario,[41] but closer to the PEP's pessimistic scenario (with real growth of 1.6%). Quarterly year-on-year growth rates fell from 4.9% in 2013Q4 to 1.5% in 2014Q1 and 0.3% in 2014Q2, before edging up to 1.3% in 2014Q3 (see Chart 1).

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

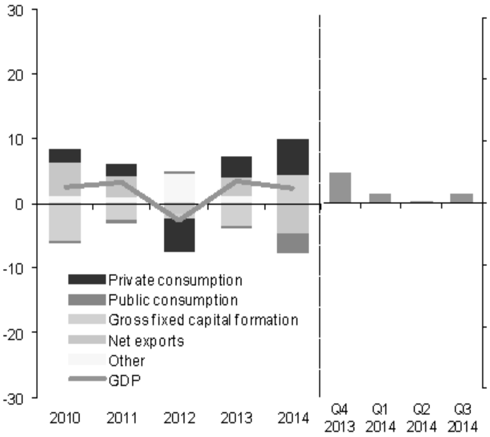
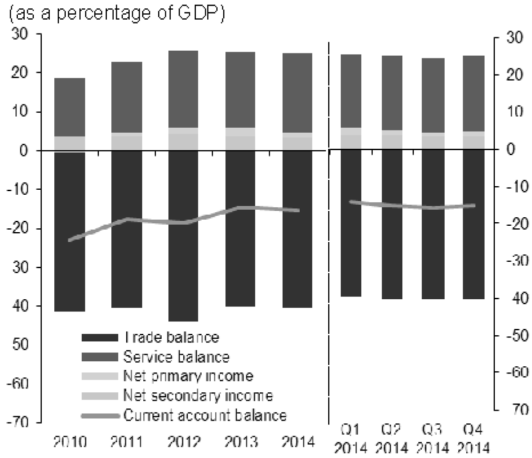


Chart 2. Components of the current account balance
(as a percentage of GDP)



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 Montenegro, IMF/WEO (figures for 2014 are projections), Haver Analytics, Statistical Office of Montenegro and ECB staff calculations.

Several factors contributed to dampening Montenegro's growth performance in 2014, including the negative effect of the devastating floods that hit the region in May, the delay of some important investment projects, and the weaker-than-expected economic performance in its main trading partners (including the euro area). Against this background, exports decreased, in particular in the electricity and aluminium sectors which resulted in a deterioration of the trade balance and a sharp drag of net exports on growth relative to 2013. On the upside, partial data suggests that the tourism sector was not (yet) significantly affected by the Russia/Ukraine crisis. Overall, private consumption and gross fixed capital formation were the main drivers of growth in 2014.

[41] Projections by international institutions were only slightly less optimistic at the time, hovering around 3-3½%.

As in previous years' PEP documents, a robust recovery is foreseen over the NERP baseline horizon. Real GDP is expected to expand by 3.5% in 2015,[42] with growth prospects depending to a large extent on projected investment programmes (in particular, the construction of a highway section which is set to start in early 2015).[43] Risks to the scenario are mainly tilted to the downside, including a further delay in (highway-related) investments and deflationary tendencies. The pessimistic scenario detailed in the NERP document assumes negative spill-overs from the situation in Russia and Ukraine[44] and no significant investment in the tourism and energy sectors, anticipating a more moderate real expansion of 2.1%. However, even in the pessimistic scenario, the assumptions on the highway project remain unchanged (see also below).

In spite of the downturn in economic activity, external imbalances remained broadly unchanged in 2014 and hence the economy remains highly vulnerable to external shocks (see Chart 2). The current account deficit is estimated to have reached 14.2% of GDP in 2014[45], and is seen to fall to 13.3% in 2015, before picking up again, reaching 13.8% in 2016 and 14.6% in 2017, according to the authorities' NERP baseline. This is a revision of earlier estimates in the 2014 PEP which anticipated a moderate shrinking of the current account deficit to 12.3% in 2016. Net foreign direct investments increased by around 9% in 2014 and are set to reach 10.2% of GDP in 2014, up from 9.7% in 2013. Net errors and omissions are high in the balance of payments which points to undeclared inflows of remittances, under-estimated revenues from tourism as well as possibly an over-estimation of imports.

External competitiveness remains a matter of concern, also on account of Montenegro's relatively narrow economic structure and its high import dependency. The euroisation regime implies that improvements in competitiveness can be mainly achieved through productivity gains or adjustments in wages and prices. The 2015 NERP contains an analysis of several competitiveness indicators. Based on unit labour costs, the country's price competitiveness improved, whereas looking at the real effective exchange rate, Montenegro's competitive position deteriorated on account of

[42] This compares to 4.6% (IMF projection), 3.4% (World Bank), 3.0% (European Commission) and 3.0% (EBRD).

[43] This section of around 40kms is part of a highway project that will connect Bar at the country's southern coast and Boljare in the north at the border to Serbia (around 170kms). It is considered of strategic importance to the Montenegrin economy by the authorities, developing poorer parts of the country in the north and boosting tourism in coastal areas. The costs of this section will exceed EUR 800 million, around 24% of 2014 GDP, and will be stretched over four years. 85% of the costs will be financed by a loan from EXIM Bank (China) and the remaining 15% from the budget.

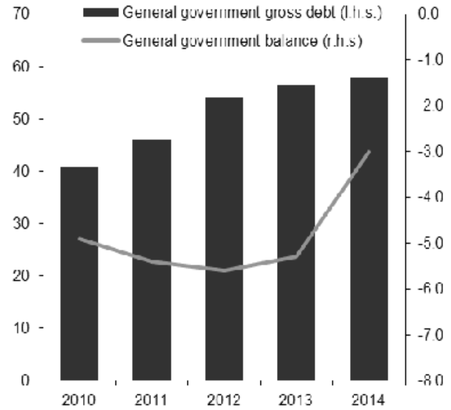
[44] The two countries account for around one third of overnight stays with the tourism sector contributing 20% to GDP. Russia also accounted for around one quarter of FDI inflows in 2014 (mainly in the real estate sector).

[45] Latest available figures, however, point to an even higher deficit of 15.3% of GDP.

the nominal exchange rate depreciation in its main bilateral trade partner Serbia.[46] Montenegro's jump in the World Bank's 2015 Doing Business ranking from 42nd to 36th place (out of 189 countries) is encouraging.

The authorities continued consolidating public finances throughout 2014, expecting a budget deficit of 3% of GDP (down from 5.3% in 2013, see Chart 3),[47] mainly on account of higher-than expected revenues but also due to lower-than-planned expenditures. On the revenue side, the hike in the VAT rate as well as the "crisis tax" top-up in the personal income tax to salaries exceeding the average remained in place, while pensions remained frozen. Additional revenues could also be collected as a result of efforts to reduce the grey economy and increase tax compliance. The public debt to GDP ratio is estimated to have reached 57.7% at the end of 2014, up from 56.5% at end-2013.[48] This compares to levels of below 30% before 2009.

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



Note: Figures for 2014 are projections.
Sources: European Commission and national authorities.

Looking ahead, the budget performance is set to deteriorate and risks to the sustainability of public finances are rising to a critical level. Expenses related to the highway project will put considerable pressure on the budget in the years to come and will require sustained fiscal discipline in other areas so as to compensate for these outlays. According to the authorities' NERP baseline scenario, the deficit is anticipated to reach 5.3% of GDP in 2015,[49] before slightly decreasing to 5.0% in 2016 and 4.0% in 2017 respectively. The Ministry of Finance calculates that it will need to borrow an additional EUR 200mn annually in 2015-2017 to finance the project, while payments for debt amortisation of more than EUR 1 billion are due over the same period. In order to partly offset the highway costs the authorities plan to introduce a special tax on fuel and raise the excise taxes on alcohol and tobacco during the course of 2015, while the "top-

[46] Even though Serbia's share in Montenegro's exports of goods decreased from 36% in 2013 to 24% in 2014, it still remained its main destination of exports. Similar effects of a depreciation of their respective currencies can be observed as regards trade relations to Russia and Ukraine but their weight in Montenegro's exports is only in the range of a combined 1-2%.
[47] It needs to be noted that in the 2015 NERP a 2014 deficit figure of 0.7% is posted. However, this figure relates to the cash deficit not adjusted by the expenditure item of repayment of debt from previous periods.
[48] 79.5% of public debt is foreign debt, up from 77.2% at end-2013, and set to reach 85% by end-2015.
[49] Cash-based.

up" rate in the personal income tax will be reduced from 15% to 13%. The government debt-to-GDP level is expected to rise further and reach its peak of 69.9% in 2018.

Despite the fact that the highway project poses the main downside risk to the fiscal baseline, the authorities' alternative scenario does not foresee any change in the assumptions about its implementation. In this context, while delays in highway implementation may be easily accommodated on the expenditure side, the potential shortfall in indirect revenues related to such a delay should not be overlooked. A further downside risk to the fiscal baseline stems from the potential calling of government guarantees, which stood at 8.8% of GDP at end-September 2014. Such guarantees are usually not subject to the same degree of scrutiny through the budgetary process as regular spending even though the contingent liabilities to the public balance sheet can be sizeable.[50] The authorities see upside risks to the fiscal scenario including from possible spill-overs from the highway project to other sectors of the economy and continued efforts to reduce the grey economy, while downside risks are identified inter alia in the delays of investment projects, geopolitical developments, demographic challenges to the pension system and increases in highway-related costs.[51]

As envisaged in last year's PEP, the Parliament adopted the Law on Budget and Fiscal Responsibility in April 2014 foreseeing the introduction of a numerical fiscal rule and a binding mid-term budgetary framework, to be implemented as of the budgetary year 2015. The aim is to introduce a two-year rolling budget, institutionalise fiscal discipline, facilitate countercyclical fiscal policy, and improve debt sustainability over the medium term. The fiscal rules foresee upper limits for public debt and budget deficits at 60% and 3% of GDP, respectively. However, the law allows breaching the limits to finance "projects of national interest" which are approved by the parliament. Furthermore, it is the government's declared strategic goal to put the debt-to-GDP level on a declining path. Nevertheless, according to the authorities' own estimates, the debt level will not follow such a downward trajectory until 2019 and will even then remain above the 60% threshold.

Inflation, exchange rates, monetary policy and financial stability

Given the unilateral euroisation regime and the high import orientation of the economy, inflation rates in Montenegro are strongly influenced by international

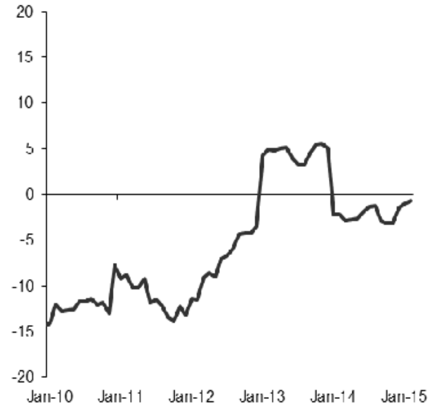
[50] This was proven by the call of government guarantees of around 3½% of GDP in 2013 for the insolvent aluminium smelter KAP.

[51] It needs to be noted in that context that the loan to finance the highway project is denominated in US-dollar which– having in mind the recent significant devaluation of the euro against the US-dollar – poses a significant exchange rate risk to the budget.

price developments. Annual CPI inflation rates slipped into negative territory in 2014 weighed down by lower food and energy prices, with a trough of -1.4% in April (see Chart 4). Since then the rate has increased, reaching -0.3% in December, with higher food prices more than offsetting the renewed downturn in global energy prices. The annual average inflation rate for 2014 thus decreased to -0.7% down from 2.2% in 2013, and significantly below the authorities own projection for the year as detailed in the 2014 PEP document (2.9%). For 2015, the authorities' baseline scenario foresees a year-end inflation rate as measured by the CPI index of 1.0%,[52] which seems to be in line with market inflation expectations.

Chart 4. Consumer price inflation
(annual percentage changes)

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



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

Credit risk remains a near-term challenge to financial stability on account of high non-performing loans on banks' balance sheets and nominal credit growth stuck in negative territory (see Chart 5).[53] Non-performing loans stood at 15.9% of total loans at end-2014, down from 17.5% at end-2013. The banking sector appears to exhibit sufficient capital buffers to deal with lingering challenges to asset quality in the period ahead though provisions differ widely across banks and NPLs net of provisions to capital remain high. Some banks have outsourced parts of their NPLs portfolio to factoring companies set-up by parent entities, implying that they are outside the domestic banking system but also outside the oversight of the host supervisor. The law on voluntary restructuring of loans ("Podgorica approach") has been brought to Parliament. While the framework still needs to be tested, it will only address the flow (as opposed to the stock) problem and will only target solvent firms with temporary cash flow or liquidity problems,

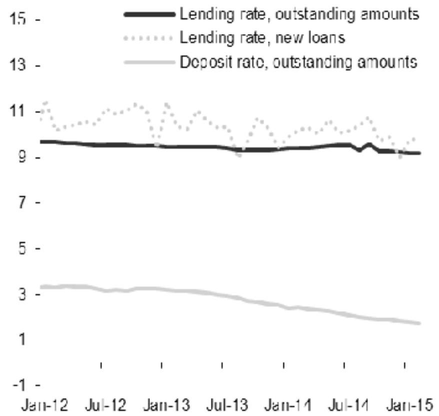
[52] The reporting on inflation projections has changed from average rates in the 2014 PEP to year-end rates in the 2015 NERP.

[53] There was a methodological change in the calculation of credit growth figures in 2013 such that the figures before this date are not fully comparable.

such that the situation of inviable corporates will still need to be addressed. Progress in NPLs disposal by banks is also seen to depend on the improvement of the legal and regulatory environment, including as regards the enforcement of procedures for collateral execution. Banks have submitted plans for NPLs management to the central bank (in accordance with the latter's Decision on Minimum Standards for Credit Risk Management in Banks from November 2013), but this does not foresee a curbing of the NPLs ratio for the banking system as a whole until end-2016. While risks to banks' funding base have diminished due to a growing reliance on domestic deposits as a source of finance, the loans to deposit ratio remained high at 103% in end-2014. In a medium-term context, risks to financial stability stem from the potential impact of bank restructuring, particularly insofar as a number of key parent entities with locally systemic subsidiaries are concerned.

Lending rates applied by commercial banks are slowly declining from a high level, but spreads with respect to deposits remain elevated (see Chart 6). The central bank's July 2014 recommendation to banks to lower lending rates thus seems to have had some traction, though it is understood that this was combined with a warning that caps on interest rates might be otherwise re-introduced. However, the spread of lending over deposit rates has remained elevated. Banks' perception is that this primarily reflects the high credit risk which remains in the system and the weak regulatory environment. Authorities hope that introducing even more competition in the system would be conducive to a reduction in these risk premia. In 2014 and early 2015, two more banks entered the Montenegrin banking system while two others have submitted a request to be licensed.

Chart 6. Commercial banks' lending and deposit rates



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

Follow-up to the Conclusions of the 2014 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

The 2014 ECOFIN Council conclusions identified a number of areas for further policy action by Montenegrin authorities, including the need to steer public debt into a downward trajectory and to implement effectively the law on Budget and Fiscal Responsibility. As spelled out above, public debt has been rising and is planned to be on an upward path for the years to come passing by a wide margin the 60% of GDP limit. An exception clause has been used to justify budget deficits above the 3% of GDP limit for the 2015 budget. Also for the years to come, deficits exceeding the threshold are foreseen. Furthermore, the Council conclusions included a recommendation to implement the voluntary financial restructuring programme ("Podgorica approach") to address the high burden of NPLs both from a stock and flow perspective. While the respective law has been brought to parliament, it still has not been adopted and overall progress with the restructuring of non-performing loans is limited.

3. Assessment

Montenegro's monetary policy regime choice severely constrains the authorities' degree of policy freedom, thus putting a higher onus on sound policy execution in the fiscal and structural domain. Further progress needs to be made in order to increase the competitiveness of the Montenegrin economy, reduce external vulnerabilities and to diversify the sources of growth, inter alia by putting public finances on a sustainable footing and improving the business environment as well as labour market conditions.

The new rules-based fiscal framework is a welcome step but needs to be complemented by a stronger enforcement framework, in particular as regards corrective measures, including deadlines for their implementation. The framework's credibility is hampered when right from the first year of implementation exceptional clauses are used to justify deviations from established objectives, and when the debt and deficit levels over a four year-horizon are not seen to reach the stipulated objectives. Challenges to fiscal policy implementation and to building up a credible track record under the new framework will be sizeable, including through potential downside risks materialising related to the highway project, high contingent liabilities to the public balance sheet possibly being made explicit, large medium-term refinancing needs (even abstracting from the highway project), and increasing public indebtedness. A medium- to long-term plan to put public finances on a sustainable footing is thus of the essence, including a fundamental expenditure reform. Strong fiscal discipline will be necessary over a long period of time to manage fiscal risks.

Reducing credit risks in the banking system through stepped-up measures for NPLs resolution remains a key policy priority for both financial stability and

financial intermediation. In this context, the foreseen implementation of the law on voluntary restructuring of loans (“Podgorica approach”) would be a welcome step but would need to be complemented by additional measures to address the stock of NPLs, the situation of unviable corporates, and the legal and regulatory bottlenecks which are still seen to hamper the disposal of impaired assets by banks, respectively. Overall, this suggests that a comprehensive strategy towards NPLs resolution should remain high in the authorities’ policy agenda for 2015, as already highlighted in the ECB’s 2014 PEP assessment for Montenegro.

Looking ahead, an over-reliance on public infrastructure projects for the development of the country should be avoided, especially against a backdrop of lingering external vulnerabilities. A re-orientation towards investment, including in infrastructure, is more sustainable than the pre-crisis private consumption-based model provided that domestic sources of growth (production, trade, tourism) would be strengthened over time, as projected by the authorities. However, as already outlined in the ECB’s 2014 PEP assessment, public projects such as the on-going highway construction will be import-intensive, leading to a likely worsening of external balances at first. They will also pose a sizeable challenge to public finances over a sustained period of time, again leading to an initial deterioration in the fiscal stance. The fact that sunk cost of such projects is initially high while the payoffs only accrue at best over a protracted period of time is thus something which needs to be duly taken into account by domestic policy makers.

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 for all months until end-2016 at the level of 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 departs 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 indicating 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 (set at the policy rate ±2.5pp). 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

Economic growth, external sector and fiscal developments

The economy contracted in 2014, dampened by heavy floods in the spring amid a weak external environment. Real GDP dropped by 3.8% and 1.8% y-o-y in the third and fourth quarter of the year, respectively, with all the main components of domestic demand registering negative rates of growth (see Chart 1). For 2014 as a whole, the most recent figures by the Serbian statistical office projects the second recession in three years, with real economic activity set to fall by 1.8%.

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

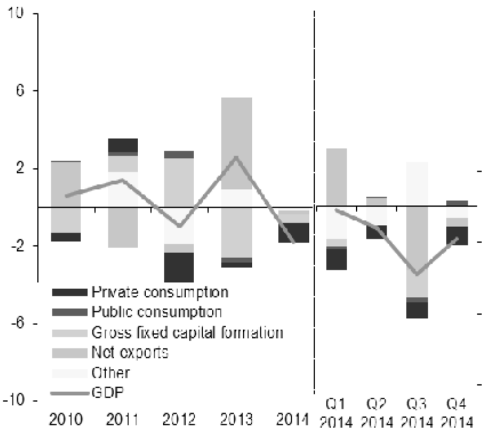
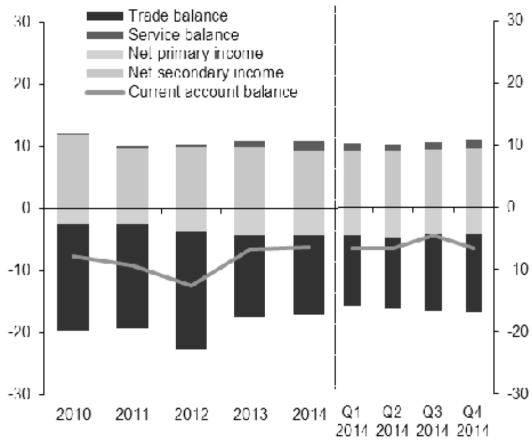


Chart 2. Components of the current account balance
(in percentage of GDP)



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: Haver Analytics, National Bank of Serbia, Statistical Office of the Republic of Serbia and ECB staff calculations.

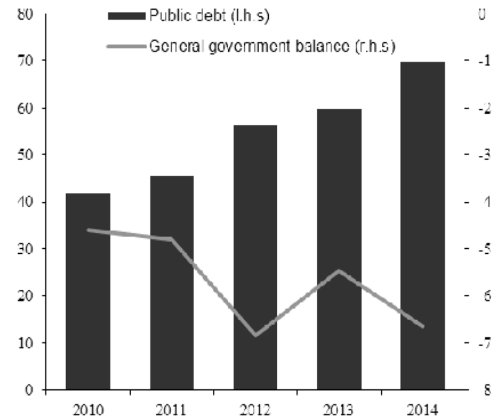
Projections for the short- and medium-term indicate a moderate recovery path. Both national authorities and IFIs expect real GDP to contract mildly by 0.5% in 2015, mainly on account of the effect of the foreseen fiscal consolidation measures as agreed under the IMF-supported programme on domestic demand. Its baseline scenario anticipates a medium-term economic recovery on account of a virtuous circle of positive confidence effects, falling interest rates, improved competitiveness and higher FDIs, supported by further monetary policy easing and structural reforms. Real GDP is thus forecast to accelerate to 1.5% and 2.0% in 2016 and 2017, respectively, according to the projections detailed in the authorities' NERP document, and to stabilise around its potential growth rate of 3% thereafter. Risks to the outlook appear largely tilted to the downside, including the potential for less supportive external demand as well as possible slippages in fiscal consolidation.

The reduction in external imbalances has ground to a halt in 2014, partly due to the impact of the floods, though coverage through FDIs remained robust. The improvement in the current account deficit observed in 2013 (to 6.1% of GDP from an average of almost 12% in the previous 5 years) was interrupted in 2014, with the trade balance weighed down by higher energy-related imports in the aftermath of the floods as well as by a weaker than expected external demand (see Chart 2). According to the most recent official figures, the current account deficit is estimated by to have widened to +6.2% of GDP for 2014, implying still large external imbalances. Still, net FDI inflows have remained robust, helping to cover almost two-thirds of the current account gap.

However, total external debt remains high at around 84% of the projected GDP for 2014 therefore pointing to a lingering sign of vulnerability for the Serbian economy. Coupled with the fact that only a small share of FDIs (especially greenfield) has been directed towards the tradable sector, this clearly underscores the need to engage in deep-seated structural reforms so as to improve competitiveness and thereby support a sustainable external balance position. Serbia's fx reserve position still appears adequate at almost EUR 10 billion in December 2014 (thus amounting to more than 6 months of imports of goods and services), notwithstanding the frequent sales interventions by the NBS in the second half of 2014.

In spite of the authorities' efforts towards fiscal adjustment, the year-end headline deficit worsened largely on account of the floods. The new government resulting from the April 2014 elections took a number of steps to begin to revert Serbia's track record of sustained fiscal profligacy in recent years.[54] However, the flood-induced recession and the ensuing recovery-related spending derailed the envisaged fiscal path. The consolidated general government deficit for 2014 was 6.6% of GDP (see Chart 3), in line with authorities' initial estimates in the NERP, but representing a further deterioration with respect to the 5.5% of GDP deficit recorded in 2013. As a consequence, the stock of public debt has further increased to almost 71% of GDP for 2014 (up from 61.4% a year earlier).

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



Source: National authorities.

In order to help bring public finances to a sustainable footing, authorities agreed to embark into a new IMF programme. The 36-month EUR 1,122 million Stand-By Arrangement agreed in February 2015 is intended to be precautionary in nature. The programme aims to stabilise the public debt-to-GDP ratio by 2017 and put it firmly on a downward path thereafter. The frontloaded fiscal consolidation strategy includes, inter alia, public wage and pension bill reduction, public wage system reform, 'rightsizing' of general government employment, reduction of direct subsidies and support to SOEs and strengthening of the fiscal framework by improving fiscal governance and public financial management. On the revenue side, efforts will focus primarily on the efficiency of tax

[54] The legislated consolidation measures included a new solidarity tax on public wages, a strict control of employment dynamics in public administration and an increase in the lower VAT rate from 8 to 10%.

collection, broadening the tax base and combating the grey economy. The baseline programme scenario (also in line with the NERP document projections) thus foresees the consolidated general government deficit to progressively decline from 5.9% of GDP in 2015 to 3.8% of GDP in 2017, while the public debt-to-GDP ratio is planned to peak in 2016 (to 79.2%) and to decline afterwards. Given debt dynamics in recent years, very ambitious measures are required to ensure a breaking of the trend and a reaching of a sustainable downward path.

Despite the fiscal adjustment underway, curbing public indebtedness will remain challenging and requires a sustained effort on the part of domestic authorities. A sizeable part of the envisaged fiscal adjustment seems to be predicated on the authorities' ability to deliver in areas where implementation risks remain high, such as the 'rightsizing' of the public sector and the restructuring of state-owned enterprises. The sensitivity of debt dynamics to negative external and idiosyncratic shocks is also magnified on account of the large gross financing needs of the public sector going forward (expected to average 17.5% of GDP in 2015-17 according to the IMF) and the vulnerable composition of debt (with 59% of total public debt denominated in foreign currency, of which 30% is in USD and 42% is in EUR).

Inflation, exchange rates, monetary policy and financial stability

Inflation fell to record lows due to contracting domestic demand and low imported inflation. Weak inflationary pressures reflected the interplay of several factors, i.e. low aggregate demand, relatively stable exchange rate in the first half of 2014, and reduced cost-push pressures on food prices thanks to a better-than-expected harvest (see Chart 4). Lower oil prices and the absence of adjustment of regulated electricity prices also played a role in headline inflation undershooting the target. Price stability has thus been maintained against the backdrop of a weak economy, though the average headline inflation was close to 2% in 2014 and thereby well below the lower bound of the central bank's inflation target (of 4% around a symmetric 1.5pp tolerance band).[55] Core inflation as well seems to have stabilised at around 2.3% since the second half of 2014, thus pointing to the presence of more broad-based disinflationary factors. Inflation is expected to remain subdued going forward amid weak domestic demand, and is only foreseen to return within the tolerance band by the end of 2015 helped by the lagged

[55] In accordance with the Agreement on Inflation Targeting Between the NBS and the government, adopted in December 2008, central bank governor Tabakovic had to write a letter in September 2014 in order to explain why inflation moved away from the target tolerance band, to describe the measures that will be taken with a view to maintaining inflation within the target tolerance band in the medium-term, and to set out the period within which we expect inflation to return within the band.

effect of the sharp dinar depreciation observed in the second half of 2014 and an expected increase in administered prices.

Chart 4. Consumer price inflation
(annual percentage of GDP)

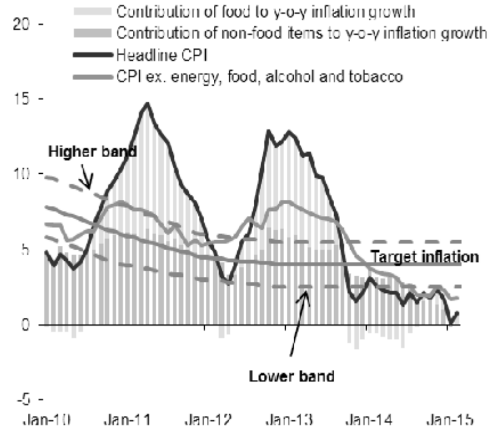
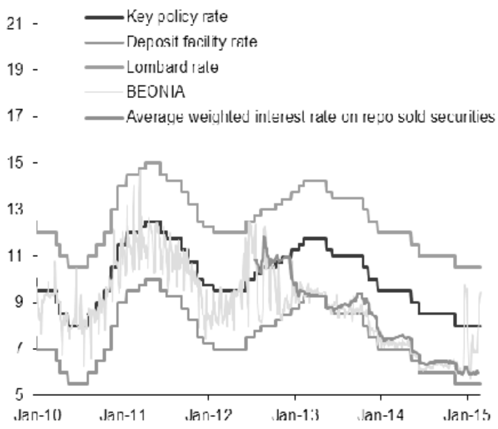


Chart 5. Interest rates
(in percent)



Note: Core inflation excludes energy, food, tobacco and alcohol.
Sources: Haver Analytics, National Bank of Serbia and ECB staff calculations.

The NBS has continued its cautious approach to relaxing the monetary policy stance, aiming to support the bank lending channel amid a challenging domestic and external environment. The central bank cut rates by a cumulative 150bps in 2014 and by a further 50bps in the year to end-March 2015, leaving its key reference rate at a historic low of 7.5%. Caution on the policy easing side was dictated by the NBS' need to cement anti-inflationary credentials following past instances in which actual inflation deviated significantly from established objectives, as already highlighted in the 2014 PEP assessment, as well as by the pace of fiscal consolidation amid an uncertain international environment. In a bid to encourage bank lending in an economy where 73% of the total loan stock is denominated in fx, the NBS repeatedly lowered reserve requirements on banks' foreign exchange liabilities. Nevertheless, the NBS' limited absorption through its open market operations of commercial banks' liquidity surpluses has meant that the gap between the key policy rate and the average reverse repo rate has remained broadly unchanged in 2014 (see Chart 5). This discrepancy between de jure and de facto short-term interest rates thus continues to send uncertain signals about the central bank's monetary policy stance.

Looking forward, under certain conditions the NBS would appear to have room to continue on its policy easing cycle in an environment where economic activity is expected to remain subdued and inflation expectations seem to be consistent with the monetary authorities' central inflation target.[56] Other things being equal, the extent to

[56] According to the February 2015 Inflation Report, both the one- and the two-year ahead inflation expectations of the financial and corporate sectors hovered around the central target of the band (i.e. 4%).

which (currently high) real interest rates can be effectively reduced will largely depend on further progress towards sustained fiscal adjustment. In particular, confidence about the future orientation of fiscal policy would help assuage financial stability concerns stemming from potential adverse changes of international investors' risk perception towards the country, e.g. through abrupt exchange rate depreciating pressures, in a context where external sovereign borrowing needs remain high and liability euroisation is dominant. Coupled with the high level of NPLs, liability euroisation impairs the efficiency of the monetary policy transmission mechanism and hence the overall effectiveness of the central bank's monetary policy under the inflation targeting framework.

The NBS intervened heavily in the foreign exchange market, particularly on the selling side. The dinar depreciated by 5.3% and 17% in nominal terms against the EUR and the USD in 2014, respectively. Against this background, the central bank has been mostly active on the fx selling side, with interventions over the year amounting to EUR 1.9 billion fx sales against just EUR 0.3 billion of fx purchases (see Chart 6).

Chart 6. Exchange rate variations

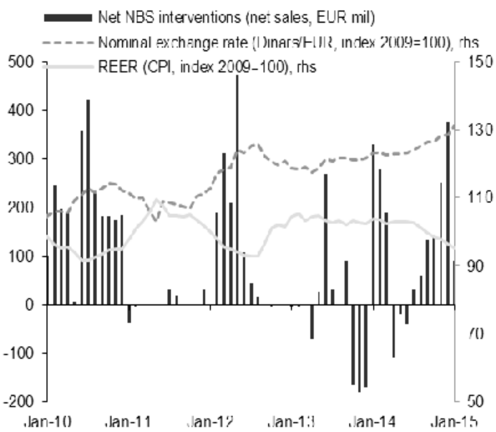
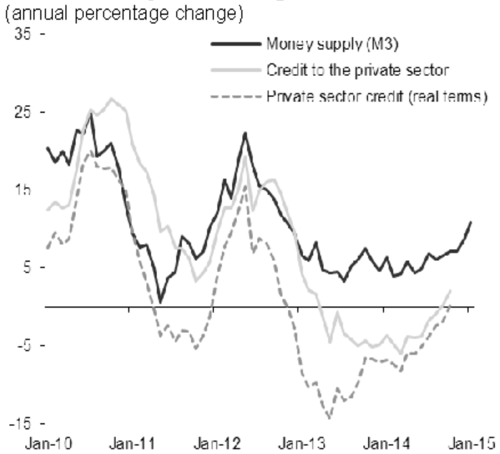


Chart 7. Money and credit growth
(annual percentage change)



Sources: Haver Analytics, IFS, National Bank of Serbia, Thomson Reuters and ECB staff calculations.

Lending activity has remained sluggish in spite of domestic authorities' efforts. The annual pace of banks' credit extension to the private sector returned to positive territory in September 2014, following a 15-month period of year-on-year declines, and has gained some traction since that time (Chart 7). The pick-up in credit growth is seen to reflect both the easing of macroprudential requirements by the NBS (including as regards fx reserve requirement ratios) as well as a government subsidised credit scheme which became operational in 2014Q2 for a total amount of RSD 136 billion (about 8% of the outstanding credit stock by end-2014). However, the sustainability of this trend going forward remains in doubt since most of the resource envelope for the authorities subsidised credit scheme has been exhausted, banks are reported to be further tightening lending standards across the board amid a subdued economic outlook, and loan applications by households are projected to decline on account of the impact of authorities' fiscal consolidation measures, respectively.

Challenges to bank asset quality are still of concern in the near-term. The banking sector has remained broadly resilient and continues to exhibit ample capitalisation and liquidity buffers. On the positive side, it is increasingly reliant on deposits as a funding source, largely due to a combination of moderate but steady deposit growth and continued decline in parent funding of the Serbian subsidiaries of foreign banks arising from low credit demand. However, the stubbornly high share of NPLs still gives cause for concern, which have remained broadly unchanged throughout 2014 (at 22.5% of the stock of total loans in November 2014). Although total loan provisioning remains healthy,[57] such a high level of NPLs represents an enduring challenge with both financial stability and real economy implications, since credit losses sap bank profitability and increase banks' aversion to new lending to the private sector. NPLs resolution should therefore remain at the forefront of the authorities' agenda in the period ahead, also with a view to increasing the overall effectiveness of any further monetary policy easing measures taken by the NBS.

In the medium-term, risks to financial stability continue to stem from indirect market risks to banks and potential bank restructuring. While the share of dinar-denominated loans in total loans received a boost in 2014H2 on account of the authorities' subsidised lending scheme, this still only accounted for under a third of the total loan stock in 2014Q3. This implies that banks' indirect exposure to market risks in the event of adverse exchange rate developments materialising (through unhedged borrowers) still give cause for concern in a medium-term context. Another risk to the medium-term horizon concerns the potential for bank restructuring. Authorities have taken steps to significantly strengthen the banking resolution framework in 2014, following a number of domestic (mostly state-owned) bank failures in previous years. However, potential domestic fallout from the on-going restructuring of some parent entities which have local subsidiaries operating in the Serbian market is still a factor for concern. Several initiatives have been announced in the context of the IMF-supported programme aiming to further strengthen the supervisory and regulatory framework, improving the bank resolution framework and addressing the high level of NPLs. In this context, the foreseen diagnostic tests of domestic banks would be an important element to ascertain the overall health of the banking system.

[57] Despite the high share of NPLs in total loans, the capital adequacy ratio of 19.4% indicates unimpaired stability of the domestic banking sector. Allowances for impairment stood at 56.7% of NPLs in November 2014. At 115.9% in the same month, loan loss provisions fully covered the amount of gross NPLs.

Follow-up to the Conclusions of the 2014 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

The 2014 ECOFIN Council conclusions identified a number of areas in need of further policy action by Serbian authorities, including: a) strengthening fiscal consolidation and public finance management, along with a deep overhaul of state-owned enterprises; b) address the burden of NPLs on banks' balance sheet; c) fully cement the central bank's anti-inflationary credentials; and d) implement policy measures to reduce inflation volatility, including a better communication between the government and the central bank with respect to expected changes in administered prices.

Relative to this targeted policy guidance, authorities have made significant progresses in the fiscal policy domain, adopting in the course of 2014 a series of relevant measures aimed at finally putting public debt on a sustainable path. On the contrary, advancements in the resolution of NPLs have been more muted in comparison. The central bank's policy stance has remained appropriately cautious, in light of the need to cement anti-inflationary credentials following a protracted period of time when inflation outcomes were significantly off-target. At the same time, the monetary authority is still calling for more transparency and a long-term planning in administered-price adjustments by the government.

3. Assessment

Serbia has a window of opportunity to steer the course of economic policy by breaking with past policies, characterised by recurring fiscal deficits and growing public indebtedness, and embark instead on a fundamental path of stabilisation and reform. Authorities have secured a 36-month Stand-By Arrangement from the IMF, which is intended to be precautionary, to support them in this endeavour.

Curbing the growth of public indebtedness, and putting public finances on a sustainable footing in a medium-term context, will be a key challenge going forward and requires very ambitions measures. Authorities have already taken a number of steps consistent with this objective under the frontloaded adjustment path foreseen in the IMF-supported programme. However, looking ahead, risks to implementation remain high, especially as regards the 'rightsizing' of the public sector and the rationalisation/resolution of state-owned enterprises. Shortcomings in any of these domains might compromise the baseline scenario foreseen by authorities in both the NERP document and the IMF-supported programme, as would a shift in external financing conditions in an environment where authorities' gross financing needs are set to remain substantial. Overall, these challenges imply that sustained effort towards fiscal consolidation and reform spanning across a number of years is likely to be demanded on the part of authorities before the benefits of such measures are tangible.

Increased fiscal consolidation would also afford monetary authorities greater degrees of policy freedom to support the real economy. As already noted in the

2014 PEP assessment, the burden of fiscal factors on the conduct of monetary policy making in Serbia has remained high in recent years, presenting monetary authorities with conflicting policy trade-offs between domestic and external objectives. The redressing of this burden going forward under a credible medium-term orientation of fiscal policy thus appears important on account of both its real economic implications and its financial stability dimension. This will allow the NBS to support banks' credit extension through lower nominal interest rates, while helping to fend off potential risks stemming from nominal exchange rate depreciation in a highly euroised banking system while sovereign external financing needs remain high.

Insofar as inflation expectations continue to be anchored around the authorities' central target and subject to the fiscal developments noted above, there would appear to be room for a continuation of the NBS policy easing cycle going forward. This might also lead to a normalisation of the gap between the NBS' key policy rate and the average reverse repo rate, which has remained sizeable in 2014 and risks to dilute the signalling effect of the central bank's monetary policy stance if left unaddressed.

The restoration of the bank lending channel appears to be crucial to both fend off financial stability risks and help reviving economic activity in a sustained manner, as well as to increase the overall effectiveness of monetary policy. The burden of NPLs on banks' balance sheets remains high and, while total loan provisioning and bank capitalisation appear adequate, lingering challenges to bank asset quality are expected to remain going forward in the context of an economy in recession. Thus NPLs disposal continues to be a key policy priority for authorities going forward. In this context, the planned diagnostic studies would provide a relevant initial insight into banks' policies and procedures for working out distressed loans.

In a medium-term context, easing the constraints on monetary policy making derived from the high degree of asset and liability euroisation in the banking system also appears as a key policy challenge. The need to revive the overall pace of credit extension amid a heavily euroised system (including through reductions in fx reserve requirements) has entailed a less supportive environment towards dinarisation than would have otherwise been the case, notwithstanding the influence of the subsidised credit scheme pursued by authorities. In a medium-term context, a greater weight of the dinar in the financial system would also help to fend off potential financial stability risks to banks stemming from adverse exchange rate developments and unhedged borrowers. The maintenance of low and stable inflation amid broad-based macroeconomic stability appears as an integral element in for any successful strategy to increase the role of the domestic currency in the financial system as a whole.

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,[58] 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 2015-2017 the inflation target has been set at 5.0% surrounded by a ±2pp band. If inflation falls outside this band at the end of a year, 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

[58] According to the IMF's classification of de facto exchange rate arrangements.

using the ROM:[59] 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.

2. Economic and financial developments

Economic growth, the external sector and fiscal developments

Economic activity has decelerated notably in the course of 2014, following a robust 4.1% expansion in 2013 on the back of supportive monetary and fiscal policies (see Chart 1). After a relatively strong performance in the first quarter of 2014 (+4.9% y-o-y), GDP rose more moderately in the second (+2.3% y-o-y), third (+1.9% y-o-y) and fourth (+2.6% y-o-y) quarters. Particularly domestic demand started to wane, primarily as a consequence of vigorous monetary policy tightening in early 2014, macroprudential efforts to rein in retail lending, high inflation and elevated political uncertainty, but picked up again in the fourth quarter. This weaker domestic demand also resulted in declining imports over the first three quarters of 2014 which – in combination with solid exports – contributed to a positive contribution of net trade to growth over that period.

For 2015, the Turkish authorities anticipate the economy to grow at a modest pace. According to the government's medium-term programme of October 2014, GDP is projected to increase by 4.0% in 2015. Demand is expected to shift back to domestic drivers with rapid disinflation and a more accommodative monetary policy supporting a pickup in private consumption and investment. By contrast, the dynamism of exports is seen to fade as a result of a subdued outlook for the EU and weaker demand from oil producing countries in the region.[60] Compared to the projections in the medium-term programme, forecasts provided by market analysts and other institutions are somewhat less optimistic. Latest consensus figures for February 2015 put GDP growth at 3.4% in

[59] 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.

[60] The EU is accounting for about two fifths of Turkey's merchandise exports. Taken together, oil and gas producing countries in the wider region (Algeria, Azerbaijan, Iran, Iraq, Kazakhstan, Libya, Russia, Saudi Arabia, Turkmenistan and the UAE) are purchasing more than a quarter of Turkey's merchandise exports.

2015, in line with the IMF (3.4%) but slightly below the ECB's 3.6% from the March 2015 MPE and the European Commission's 3.7% estimate.

Despite a notable improvement in the trade balance, Turkey's current account deficit continues to be sizeable. Mainly reflecting a cooling of domestic demand and a healthy increase in exports, it has shrunk considerably from the 7.9% recorded at the end of 2013 but registered at a still high 5.6% of GDP at end-2014 (see Chart 2).

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

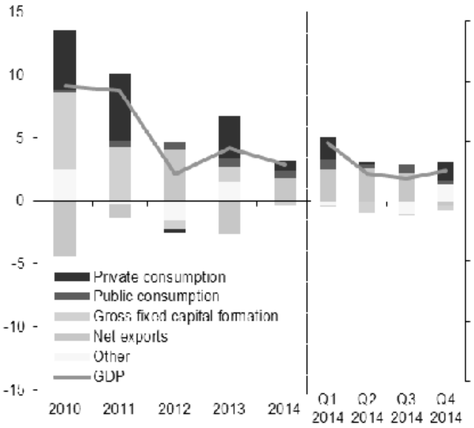
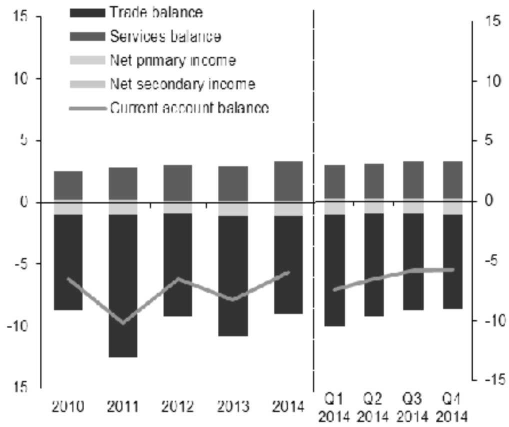


Chart 2. Components of the current account balance
(in percentage of GDP)

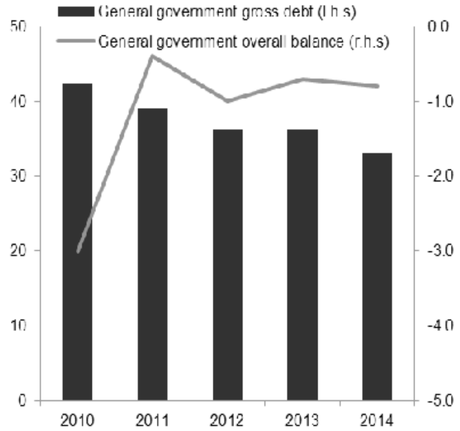


Notes: Quarterly figures for the current account balance are a moving sum of the most recent four quarters. In the case of contributions to real GDP growth, annual growth with respect to the same quarter a year earlier.
Sources: Turkish Statistical Institute, Haver Analytics and ECB staff calculations.

Moreover, the external funding needed to finance the current account shortfall has predominantly been sourced from short-term (net) portfolio flows (2.5% of GDP) or debt-creating (net) other investment flows (2.2% of GDP) whereas (net) foreign direct investment has contributed a mere 0.7% of GDP. As a result, Turkey's gross external debt has climbed to 50.3% of GDP in end-2014, up from 47.3% at the end of 2013, as particularly private banks have expanded their external liabilities to 20.6% of GDP from 18.2% of GDP. Overall, balance of payments developments up to the third quarter of 2014 allowed the CBRT a slight accumulation of reserve assets amounting to 0.4% of GDP, which later declined by the end of the year. For 2015, the government's medium-term programme foresees the current account deficit to fall to 5.4% of GDP. However, the steep drop in energy prices since November 2014 is likely to trigger an even stronger contraction in light of imports of fuel products (4.4% of GDP in the third quarter of 2014) accounting for a substantial share of Turkey's current account balance.

Higher than anticipated revenues have kept the budget deficit in check in 2014, notwithstanding some expenditure overruns, partly in the context of a busy electoral schedule. Hence, the central government budget deficit has reached 1.3% of (forecast) GDP in 2014 (see Chart 3).[61] For the coming years, the government's medium-term programme foresees some tightening of fiscal policy, containing the deficit at 0.3% of GDP in 2017, also in order to contribute to a reduction in Turkey's large savings-investment gap. Government debt, at less than 36% of GDP in the third quarter of 2014, has followed a declining trend since 2009 and is intended to be reduced by about another five percentage points of GDP until the end of 2017.

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



Note: Figures for 2014 are projections.
Source: National authorities.

Inflation, exchange rates, monetary policy and financial stability

Inflation has moderated recently but has stayed above the upper (7%) bound of the CBRT's uncertainty band (see Chart 4). At 7.6% y-o-y in February 2015, inflation has retreated from a peak of 9.3% y-o-y in November 2014, as some one-off factors adversely affecting prices have begun to subside, such as the lagged pass through from the lira's depreciation between May 2013 and January 2014 (see Chart 5),[62] and unfavourable weather conditions in the spring and summer of 2014 sustaining elevated food inflation. Furthermore, the sharp decline in oil prices has started to represent an additional drag on inflation. Incorporating these tentative signs of abating price pressures into its inflation outlook, the CBRT is expecting inflation to return to 5.5% y-o-y by the end of 2015 whereas survey-based measures see a rate of 6.8% y-o-y in December 2015, roughly similar to the IMF's 6.2-6.5% estimate.

In spite of inflation persistently above target and further rising inflation expectations, the CBRT adopted a policy of gradual monetary loosening in the spring of 2014 (see Chart 6). Unwinding some of the steep 550 bps hike of January 2014, the CBRT had lowered its main policy (one-week repo) rate from 10.0% to 7.5% by March 2015, bringing the real policy rate into negative territory. Nonetheless, the CBRT characterised this monetary stance as tight, emphasising its focus on the yield

[61] WEO projections for 2014 as slightly less optimistic nevertheless, with a general government deficit of 2% of GDP.
[62] According to CBRT estimates, a 10% decline of the exchange rate is translating into a 1.5 percentage point rise in consumer price inflation, four fifths of which materialises after a period of six months.

curve which was to remain flat until a significant improvement to the inflation outlook would have taken place. While money market rates initially mirrored the decline in the one-week repo rate, the CBRT adjusted its liquidity operations in September 2014 to guide interbank funding costs towards the upper end of its interest rate corridor. This step was primarily taken to provide support to the lira, following heightened international financial market volatility in view of global growth concerns at the time.

Chart 4. Consumer price inflation
(annual percentage change)

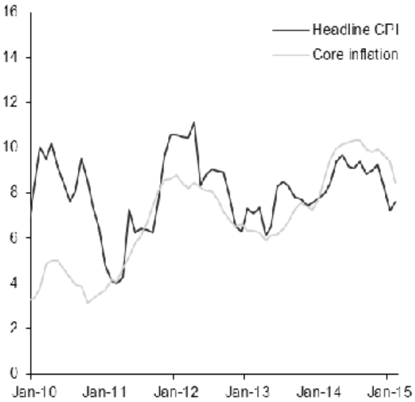


Chart 5. Nominal exchange rate
(Turkish lira per euro)

Note: Core inflation excludes unprocessed food, energy, alcoholic beverages, tobacco products and gold.
Sources: Central Bank of the Republic of Turkey, Haver Analytics and Turkish Statistical Institute.

Since then, however, the CBRT has largely maintained tighter money market conditions, effectively leaning towards a lessening of policy accommodation. As Turkish banks tend to price loans off the overnight lending rate if liquidity is scarce, this has also rendered real borrowing rates for the economy marginally positive. At the same time, the CBRT's present stance underscores the more symbolic nature of the 75 bps of cuts to the one-week repo rate in 2015 to date, making the 50 bps reduction to 10.75% in the overnight lending rate on 24 February the more relevant decision.

Apart from modifications to interest rates and liquidity conditions the CBRT also relied on its other instruments to achieve its policy goals. Most notably, the CBRT introduced the remuneration of lira required reserves in October 2014, with the interest paid depending on the capitalisation and loan-to-deposit ratio of each individual bank, giving the scheme some features of a macroprudential measure. Moreover, compensating banks for the maintenance of lira reserves diminishes the attractiveness of holding US dollars or gold instead in the framework of the ROM, albeit only at the margin. At the beginning of 2015, the CBRT changed the reserve requirement ratios on banks' foreign currency liabilities by increasing the implicit charge on short-term funding to the benefit of financing with a longer maturity. To compensate banks for the resulting withdrawal of foreign currency liquidity, the ROM was amended in parallel. Lastly, the

CBRT repeatedly altered the terms of its daily foreign currency auctions and implemented other measures to meet the foreign currency needs of the economy,[63] also with the intention to address undesired exchange rate volatility and to manage its foreign exchange reserves.[64]

Chart 6. Interest rates
(percentages)

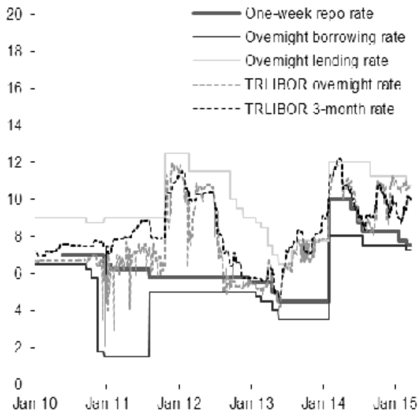
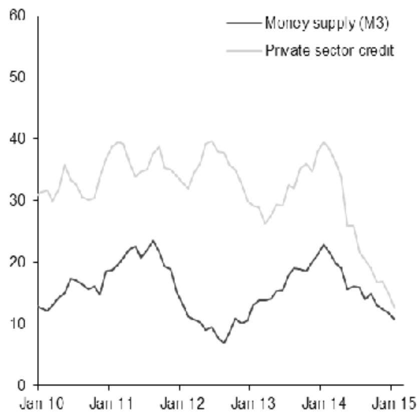


Chart 7. Money and credit growth
(annual percentage change)



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

Turkey's financial institutions appear resilient overall but the exposure of corporates to exchange rate risk and the substantial accumulation of short-term external liabilities by banks warrant attention. Indicators of bank profitability and capital adequacy have remained robust but have been on a declining trend since 2009, also reflecting the strong origination of credit that has taken place during this period (see Chart 7). In the third quarter of 2014, the return on assets and equity of Turkish banks stood at a respective 1.7% and 15.2%, compared with 2.2% and 19.0% at the end of 2013. This decline is primarily related to a slowing economy, higher financing costs as a result of the CBRT's firm policy tightening at the beginning of 2014 as well as the implementation of measures by BRSA to curtail retail lending growth and to cap banking fees. At the same time, capital adequacy, at 15.3% at the end of 2013, improved to 15.9% by the third quarter of 2014, comfortably above the legal minimum of 8% and the CBRT's target ratio of 12% with around 85% of capital classified as Tier-1. In addition, a mere 2.8% of total loans were registered as non-performing in the third quarter of 2014,

[63] For example, Turkey's energy-importing state-owned enterprises were granted permission in December 2014 to obtain foreign currency directly from the CBRT or the Treasury instead of purchasing the amounts needed to pay for their imports on foreign exchange markets.

[64] At the end of 2014, the CBRT held international reserves worth USD 142 billion, nearly the same as at the end of 2013 (USD 148 billion). However, about USD 81 billion of these assets are directly attributable to Turkish banks since they are replacing required lira reserves via the ROM. In case of potential external financing constraints, these funds constitute an important buffer for financial institutions as they are roughly equivalent to their outstanding stock of short-term external debt (USD 80 billion). Nevertheless, they leave the central bank with only about USD 41 billion of liquid foreign currency reserves at its disposal once its USD 20 billion of gold holdings are taken into consideration.

which together with the banking sector's relatively comfortable capital buffer indicates some leeway to absorb a possible deterioration in asset performance. A potential source of concern is the noteworthy net open foreign currency position of Turkish companies (USD -183 billion in December 2014 or more than 20% of GDP) that makes banks' asset quality vulnerable to lira depreciation.[65] Likewise, financial institutions have rapidly expanded their short-term external debt in recent years, from USD 47 billion (6% of GDP) in 2011 to USD 80 billion (10% of GDP) in 2014. Yet, some of this risk is balanced by the sizeable stock of liquid foreign currency assets banks are maintaining as reserves at the central bank (see also footnote 7) and the CBRT's recent efforts to raise the cost of finance through short-term funding from abroad by increasing reserve requirements on this form of debt.

Follow-up to the Conclusions of the 2014 Ministerial Dialogue between the ECOFIN and the EU Candidate Countries

With regard to Turkey's monetary and exchange rate policy, the 2014 ECOFIN Council conclusions recommended the continuation of consistent steps to re-focus monetary policy on the pursuit of price stability. However, in the course of 2014 the CBRT has followed a policy stance that appears overly loose in view of inflation considerably above target and rising inflation expectations. In addition, the CBRT has reverted to a strategy of "tightening by stealth" from the fall of 2014 onwards, increasing the complexity of its policy implementation and communication. In combination with mounting government pressure to lower interest rates, the CBRT's policy approach may impair the credibility of its primary objective of price stability.

3. Assessment

Similar to previous years, inflation in 2014 has overshot the 5% target by a large margin, continuing to undermine confidence in the CBRT's commitment to its price stability objective. Survey-based inflation expectations that have persistently stayed close to or above the upper (7%) bound of the ±2pp band in recent years are evidence of a lack of credibility that the CBRT can meet its 5% target in a sustainable manner. Even though some of the factors affecting prices in the course of 2014 are indeed of a temporary nature, inflation expectations out of line with the target over such an extended period of time may point to fundamental challenges. In this context, the CBRT's reliance on fading inflationary pressures in the future – even if warranted – to justify policy rate cuts at present has to be considered an inappropriately loose monetary stance. By pursuing such a policy, the CBRT is condoning non-negligible risks to

[65] However, the Turkish authorities are pointing out that about 85% of this risk is being hedged, primarily by being concentrated among large companies with good credit quality that should have the ability to manage exchange rate risk and that dispose of foreign currency-denominated export earnings providing a natural hedge.

macroeconomic and financial stability since Turkey's external vulnerabilities remain sizeable. Therefore, potential domestic or external shocks may necessitate an abrupt policy reversal by the CBRT, comparable to the one witnessed in January 2014. Particularly, the impending withdrawal of monetary accommodation in the United States could again spillover to emerging markets whose fundamentals are perceived to be insufficiently sound, akin to the "taper tantrum" episode of high financial market volatility seen in May 2013 when also the lira came under substantial pressure.

In addition, the complexity of the CBRT's policy implementation and communication has increased again since the spring of 2014, gradually reverting to the status quo in place before the sharp interest rate hike at the beginning of 2014 triggered a concomitant simplification of the CBRT's framework. Since the first policy rate reduction in May 2014 the CBRT has described its policy stance as tight although subsequent cuts and inflation developments have gradually led real policy rates into negative territory, thereby creating an interest rate environment that would generally not be classified as tight. To offset some of this loosening later in the year, the CBRT has opted to maintain money market rates close to the top of its interest rate corridor since the fall of 2014 by varying the liquidity offered at its different facilities. Whereas such a strategy has already been employed in 2012 and 2013, a removal of monetary accommodation by raising the policy rate may have conveyed a clearer signal of the CBRT's determination to fight inflation. Finally, the CBRT has been confronted with increasingly frequent calls from the government to lower interest rates ahead of parliamentary elections in June 2015. Against this background, the – largely symbolic – decrease in the policy rate by 75bps to 7.5% in 2015 so far may create the impression that the CBRT is giving in to government pressure while trying to salvage its actual stance by keeping interbank rates in the vicinity of the overnight lending rate. Ultimately, this could harm the perception of the CBRT's independence in the longer term.

Lastly, overly loose monetary policy may prevent the achievement of some of the goals highlighted in the government's medium-term programme, specifically to sustainably bring down inflation and to lift Turkey's chronically low savings rate. 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. However, monetary policy has a role to play. In fact, high inflation in combination with very low or even negative real interest rates is unlikely to incentivise households to save. In this regard, it might be advisable for the CBRT to focus more stringently on its primary objective of price stability and leave at least some of secondary targets to be addressed by prudential, fiscal or structural policies.

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	
	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014	2013	2014
Measures of inflation *(period averages)*														
Harmonised index of consumer prices (HICP)	…	…	…	…	…	…	2.8	-0.3	1.9	-0.5	7.9	2.1	8.9	6.3
National consumer price index (CPI)	1.9	1.6	0.2	-0.9	1.8	0.4	2.8	-0.3	2.2	-0.8	7.9	2.1	7.5	8.9
Producer prices	-0.4	1.4	-1.7	-0.5	2.3	1.6	0.4	-1.2	1.7	0.2	3.6	0.7	4.5	10.3
Interest rates *(percentages, annual averages)*														
Short-term policy rate[1)]	3.6	2.6	…	…	…	…	3.3	3.3	…	…	11.1	8.8	4.8	8.6
Medium-term interest rate[2)]	…	…	…	…	…	…	…	…	5.5	3.4	4.2	3.6	…	…
Long-term interest rate[3)]	5.4	3.1	…	…	…	…	4.1	2.9	…	…	…	4.8	3.6	3.1
Deposit rate of commercial banks[4)]	7.9	7.2	7.0	6.6	12.4	10.7	7.0	6.5	10.3	10.2	11.1	9.8	9.9	11.4
Lending rate of commercial banks[4)]	2.8	1.7	3.0	2.7	3.4	1.1	1.2	1.0	2.9	2.1	2.5	1.7	3.8	4.3
Memorandum items:														
ECB main refinancing rate							0.5	0.2						
Euro area long-term interest rate[5)]							1.6	1.2						
Related indicators *(annual percentage changes unless otherwise stated)*														
Real GDP growth	1.4	2.1	2.1	0.7	3.4	2.7	2.9	3.4	3.5	2.3	2.5	-0.5	4.0	3.0
Average monthly gross wages[6)]	17.6	11.5	0.1	-0.1	-2.2	17.9	1.2	1.0	-0.2	-0.3	5.7	1.1	14.4	15.5
Price deflator for imports goods and services	1.4	1.7	3.2	2.4	0.0	0.9	4.6	5.6	…	…	5.4	2.0	-1.2	0.1
Real effective exchange rate (CPI-based)	…	…	-1.8	0.3	0.3	0.2	1.6	0.9	…	…	6.8	-2.2	-1.6	-5.6
Money supply (M2)	5.1	1.1	5.7	7.6	…	…	1.0	7.3	7.4	6.5	9.4	11.8	17.4	17.0
Private sector credit growth (annual averages), nominal	-0.2	0.1	2.2	3.1	3.6	3.8	4.1	8.3	4.6	-2.3	-0.5	-4.1	27.4	24.7
Private sector credit growth (annual averages), real	-2.1	-1.7	2.0	3.9	1.9	3.3	1.4	8.6	2.4	-1.6	-8.4	-6.2	19.9	15.9

Sources: Bloomberg, European Commission (AMECO, February 2015 revision), Haver Analytics, IMF/IFS, IMF/WEO (October 2014 revision), national sources and ECB staff calculations.

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.

5) 10-year generic government bond yield.

6) Annual change in average monthly gross wage, 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.

Macroeconomic projections

(as a percentage of GDP unless otherwise stated)

	Albania			Bosnia and Herzegovina			Kosovo			FYR Macedonia			Montenegro			Serbia			Turkey		
	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)	2014 (e)	2015 (f)	2016 (f)
Real GDP growth (%)																					
IMF	2.1	3.3	4.2	0.7	3.5	3.7	2.7	3.3	4.0	3.4	3.6	3.9	2.3	3.4	3.3	-0.5	1.0	1.5	3.0	3.0	3.7
European Commission	…	…	…	…	…	…	…	…	…	3.5	3.5	3.6	1.4	3.0	3.7	-2.0	-0.3	1.2	2.8	3.7	4.0
Current account balance																					
IMF	-11.0	-12.7	-13.9	-11.0	-9.1	-7.4	-7.2	-7.6	-7.6	-4.6	-5.7	-5.0	-17.8	-23.7	-25.1	-6.1	-5.1	-4.1	-5.8	-6.0	-6.0
European Commission	…	…	…	…	…	…	…	…	…	-2.0	-2.4	-2.2	-15.6	-15.6	-16.9	-5.8	-5.3	-5.4	-6.0	-3.6	-4.2
General government net lending/borrowing																					
IMF	-6.7	-5.9	-5.5	-4.1	-2.7	-1.4	-2.2	-4.3	-4.9	-3.5	-3.2	-2.6	-1.5	-6.6	-6.4	-8.8	-8.4	-7.2	-2.0	-1.9	-2.1
European Commission	…	…	…	…	…	…	…	…	…	-3.9	-3.5	-3.2	-3.0	-5.7	-4.8	-4.5	-4.9	-3.9	-1.5	-1.4	-1.3
General government gross debt																					
IMF	72.1	71.6	69.0	46.1	46.0	44.6	10.6	…	…	36.3	37.5	38.4	60.3	62.9	66.6	75.6	79.6	83.1	33.6	33.1	32.4
European Commission	…	…	…	…	…	…	…	…	…	38.0	39.1	40.1	58.2	62.3	65.6	69.5	76.9	81.0	34.3	32.2	31.2
Inflation (CPI change, %)																					
IMF	1.8	2.7	3.0	1.1	1.5	1.8	1.0	1.6	1.6	1.0	1.5	2.3	-0.6	1.3	1.3	2.3	3.4	4.0	9.0	7.0	6.5
European Commission	…	…	…	…	…	…	…	…	…	0.8	1.3	1.7	-0.7	0.4	2.0	2.1	3.2	4.3	8.9	6.3	5.8

Sources: IMF/WEO (October 2014 revision) and European Commission (AMECO, February 2015 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						
2012 Q4	14.6	3.8	29.4	22.5	64.5	3.7
2013 Q4	14.9	6.4	27.6	23.5	63.0	4.1
2014 Q3	14.5	11.0	32.4	25.0	62.1	6.8
Bosnia and Herzegovina						
2012 Q4	14.1	5.0	25.4	13.5	63.1	5.4
2013 Q4	15.2	-1.3	26.4	15.1	62.9	6.7
2014 Q3	15.1	5.3	26.8	16.1	61.4	6.8
Kosovo						
2012 Q4	15.0	6.8	34.3	7.4	0.2	0.0
2013 Q4	12.8	9.5	37.8	8.5	0.1	2.3
2014 Q2	13.5	9.3	32.5	8.2	0.3	2.4
FYR Macedonia						
2012 Q4	14.5	3.8	32.4	10.1	55.4	11.4
2013 Q4	14.4	5.7	31.2	10.9	52.7	15.6
2014 Q3	14.2	7.6	31.6	11.7	50.5	14.0
Montenegro						
2012 Q4	15.8	-18.3	24.0	17.6	1.9	-0.8
2013 Q4	13.0	0.5	20.0	17.5	1.6	0.6
2014 Q3	14.6	6.2	23.2	16.4	1.6	na
Serbia						
2012 Q4	19.0	2.0	34.5	18.6	74.7	2.7
2013 Q4	19.3	-0.4	38.5	21.4	71.5	1.9
2014 Q3	16.7	4.6	37.3	23.0	70.3	0.6
Turkey						
2012 Q4	15.1	19.6	50.9	2.7	25.0	0.0
2013 Q4	13.0	17.4	47.1	2.6	27.1	-3.5
2014 Q3	13.5	15.2	49.6	2.8	27.4	-3.5

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