During the past decade, the ten new EU member states reached a high degree of market integration and macroeconomic stabilization as part of their accession process. The main challenge for these countries is to deal with large and potential volatile capital inflows and to achieve nominal convergence needed for adopting the euro. These challenges must be addressed within the scope of the limited fiscal policy. In the context of macroeconomic adjustment, macrofiscal policies will be in the focus of macroeconomic policies in the years that follow. They need to focus on meeting the requirements for sustainability of EMU, and to assist in absorbing the effects of aggregate demand of large capital inflows. So in terms of macroeconomic convergence for SEE6 countries and the case of Macedonia, EU membership requires convergence of the Macedonian economy with that of the EU in realistic conditions, indicating income per capita and economic structure, and in nominal terms, meaning convergence of prices, inflation and interest rates.

Tatjana Boshkov

How to balance EU convergence & economic recovery in SEE6

Tatjana Boshkov, Assistant Professor at University "Goce Delcev", Macedonia. Research area:Exchange rate policy, International Finance, Macroeconomics, EU convergence, International trade.

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To Kalina and Goran
Which are more important that this book

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1.Introduction

According to literature, the macroeconomic policy of the new EU member states, is facing with two main challenges. The first is to manage the continued and rapid process of future real economic convergence, which will come with high real GDP and productivity growth rates and large capital inflows. The second challenge is to achieve the degree of nominal convergence required to enter into European Monetary Union (EMU). These two challenges are not unrelated, such as rapid growth and large capital inflows can make it difficult to realize nominal convergence, i.e., there are good reasons to think that the real convergence would be easier to manage for some countries, if they were allowed to adopt the euro immediately. Both challenges are mainly associated with fiscal policy: managing capital inflows, because fiscal policy can absorb some of their demand effects, nominal convergence, because the sustainability of public finances is part of the requirements for entering EMU.

2. Macroeconomic challenges for countries of South-Eastern Europe

A survey provides an interesting overview of progress with real and nominal convergence in Central and South-Eastern Europe and the macroeconomic challenges that they face on their path to the EU[1]. Namely, referring to the macroeconomic stability and progress in transition are closely related and both are important for sustainable growth and progress towards a functioning market economy. Progress with structural reforms can help for macroeconomic stability, for example, by reducing the structural external deficits. Also it helps nominal convergence, as the productivity realizes the improvement of competitiveness and helps disinflation by maintaining low unit cost.

In a study for experience about the development in the newest EU members, Fidrmuc shows that the development in more successful transition countries reflects higher total factor of productivity than the growth in relative levels of capital and

[1] Schadler, S., P. Drummond, L. Kuijs, Z. Murgasova and R: van Elkan (2005), "Euro Adoption in the Accession Countries: Vulnerabilities and Strategies", in S. Schadler ed. *Euro Adoption in Central and Eastern Europe: Opportunities and Challenges", IMF.*

labor[2]. This underlines the importance of market-established reforms for development. Various indicators show that the most of the Southeastern countries require continual progress in transition reforms to become functional market economies. As regards structural reforms, if they remain slow, positive growth rates seen in the last five years in many South-eastern European countries may not be sustainable. This would slow down real convergence. Initial reforms-like trade and price liberalization, privatization in many countries, and relative macroeconomic stability-facilitated development since 2000 in many countries in the region.

Like many countries in the early stages of transition, South-eastern European countries rely mainly on exchange rates to reduce the inflation. In many countries, exchange rate helps to reduce the inflation to lower single digits since 2004. Albania's managed float and informal inflation targeting were also successful in keeping inflation low, while in Romania, inflation, although declining under the managed float, remains close to double digits. Since 2000 Serbia has shifted between nominal and close to real exchange rate targeting (with important regime shifts in early 2003 and 2005).

Inflation first declined with the exchange rate anchor, but an increasing external deficit prompted a shift to a managed float in 2003. However, inflation resurged, as suppressed administrative prices were readjusted and growing euroization contributed to an increased pass-through from the exchange rate to prices. The regime shifts may also have adversely affected monetary policy credibility, as indicated by the growing euroization. The exchange rate anchors and sluggish structural reform put pressure on competitiveness. Fixed or nearly fixed exchange rates can lead to unsustainable real appreciation and loss of competitiveness, unless fiscal and incomes policies remain tight and structural reforms boost productivity. For example, in Serbia, the exchange rate anchor in 2002 became unsustainable as large real wage increases and slow structural reforms eroded competitiveness and increased the external deficit. Pressures for real appreciation in the region also arise from the large inflows of foreign currency. The evolution of EU export market shares also suggests that Macedonia may have lost competitiveness, while most others have increased their share in the EU market. The real effective exchange rates data (REER) show a large

[2] Fidrmuc, J. (2004), "The Endogeneity of Optimal Currency Area Criteria, Intra-Industry Trade and EMU Enlargement", *Contemporary Economic Policy,Vol. 22, No. 1, pp. 1-12.*

appreciation in Bulgaria, Romania, and Albania in recent years, which at least in the former two is likely to reflect changes in market fundamentals in terms of increased productivity. In the remainder of the SEE, there is no clear trend with real appreciation and the REERs have remained relatively flat in the past few years.

South-eastern Europe can draw experience from recent new EU member states with monetary framework during accession. Exchange rate regimes during accession had shown different variations, which indicate the importance of fundamentals and associated policies in the implementation and achievement of macroeconomic stability[3]. Some of the larger recent EU members gradually moved from exchange-rate-based stabilizations to more flexible monetary policy as transition progressed. South-eastern Europe has very lower speed of reforms and lower growth rates. Related to this, capital inflows to the region are very smaller and have shown greater dispersion between countries.

Regardless the exchange rate regime, the appreciation of the real exchange rate among countries in the region is significant, although it is slightly lower when compared to countries in the EU member states. As a result, these countries suffer from loss of competitiveness. This can be clearly seen from the movements of the deficit on their current account, which are important in all these countries. For example, the current account deficit in 2007 ranged from 3.1% of GDP in Macedonia to 36.2% of GDP in Montenegro[4]. Using the exchange rate as hope for inflationary expectations have been effective so far, producing a low and stable inflation rates. In terms of high import dependence and the relatively slow implementation of structural reforms realized in increased export potential, contributed to the importance of high trade deficit, which was largely financed by high private transfers.

3. Economic convergence of Macedonia and SEE6

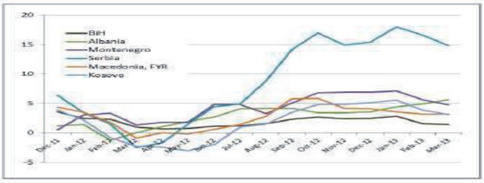
In order to accede to EMU, Macedonia should complete a real and nominal convergence. In this way, statistic show that the food prices are still the main driver

[3] Schadler, S., P. Drummond, L. Kuijs, Z. Murgasova and R: van Elkan (2005), "Euro Adoption in the Accession Countries: Vulnerabilities and Strategies", in S. Schadler ed. *Euro Adoption in Central and Eastern Europe: Opportunities and Challenges", IMF.*

[4] European Commission (2007), *The EU Economy 2007 Review, Moving Europe's Productivity Frontier.*

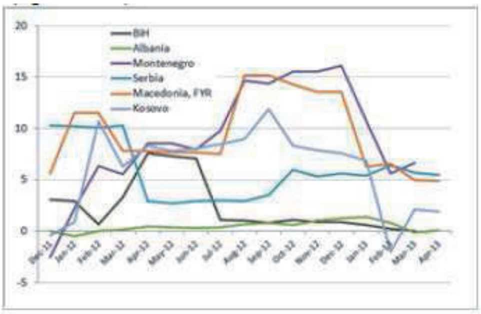
of inflation in the SEE6, but the pressures on energy prices are decreasing (Fig. 1 and 2). In the first quarter of 2013 the inflation in food prices rose by 9.3% annually, which is higher than the peak of 9.2% in the fourth quarter of 2012. With slowing consumption, global demand for oil remains passive, and the pressures of energy prices decreased practically in all SEE6.

Figure 1. Inflation in food prices in SEE6 annually in%



Source: Eurostat,World Bank

Figure 2. Price inflation in energy SEE6 annually in%

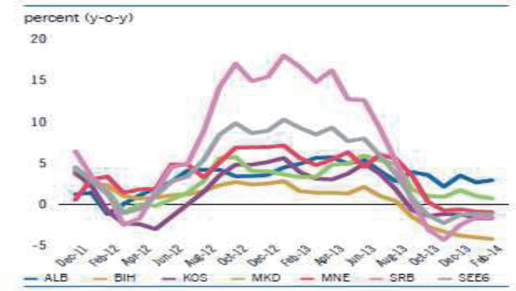


Source: Eurostat,World Bank

Inflation declined notably across the SEE6 region in the course of 2013. As the effects of increases in food and administered prices as well as taxes dissipated, the region experienced a dramatic drop in inflation rates, which turned into deflation in some countries.Falling world food prices, in particular, drove much of the drop in the CPI inflation in SEE6 in 2013 (Figure 3)[5].

[5] World Bank (2013d), *World Development Report: Jobs*, World Bank, Washington, DC.

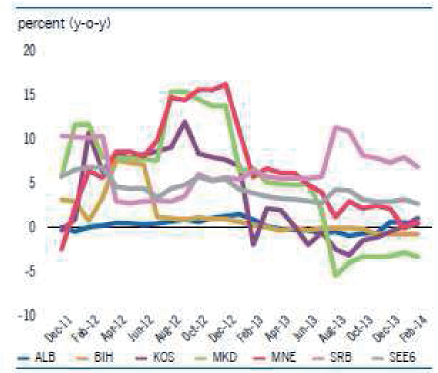
Figure 3: Food Price Inflation



Source: National statistical offices and World Bank staff calculations.

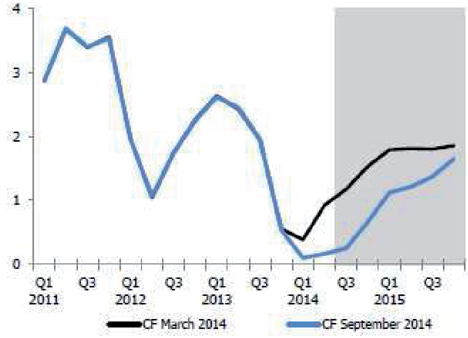
At end-2013, Serbia recorded the largest fall among the SEE6 in CPI inflation compared to December 2012 (by 10 percentage points) because of the drop in food prices. The exception was FYR Macedoniai, where inflation developments were driven by a slowdown in global energy prices and the waning effect of domestic regulated price increases earlier in 2012 (Figure 4).

Figure 4: Energy Price Inflation



Source: National statistical offices and World Bank staff calculations.

Figure 5: Foreig effective inflation
(annual rates of change in %)



Source: Consensus Forecast and NBRM calculations.

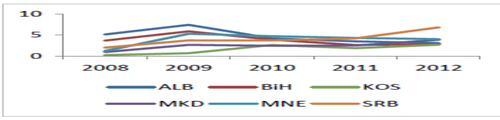
The average annual inflation in 2013 was 2.8%, which is a slowdown compared to 2012 when it was 3.3%. In the first half of the year, inflation was 3.6% on average, annually. In the second half of the year, inflation slowed down and reduced to 2% on average, as a result of the influence of all the key price components. Foreign effective inflation in 2014 is low due to the assessment for lower inflation in all Macedonian import partners, where Bulgaria and Serbia (countries with projected deflation), as well as Germany, have the greatest contribution. Assessment of foreign inflation is revised downward also for 2015 and it is now expected to equal 1.3% (Figure 5).

The following fiscal deficits in SEE6 had an upward trend in 2012, an average of 3.2% of GDP in 2011 to 3.9% in 2012 (Fig. 6)[6]. The largest increases were in Serbia by 2.6 % of GDP and in Macedonia by1.4%, mainly due to the payment of outstanding government obligations. Albania and Montenegro had the opposite trend to reduce their fiscal deficits. The region in 2012 - revenues and expenditures as a percentage of GDP, are moving in the same direction. Thus Macedonia entered as a country with a growing fiscal burden. Namely, fiscal deficits increased, for example, the income of Serbia (as a percentage of GDP) increased. Serbia has made additional efforts to increase revenues, increasing the rate of VAT and the CIT (corporate income taxes). Although both countries have benefited from increased revenues, but

[6] World Bank (2013c), *Global Economic Prospects June 2013: Looking for stable ground*, World Bank, Washington, DC.

their spending increased by 1.5 percentage points of GDP in Macedonia related to the payment of debts.

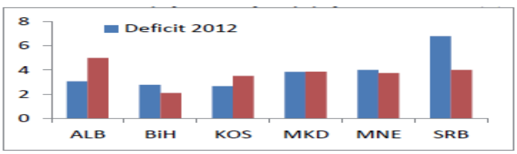
Figure 6: Fiscal deficits (% of GDP)



Source: Eurostat

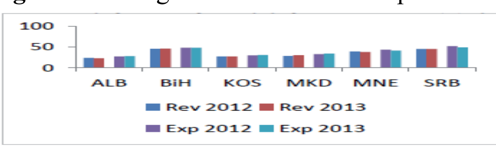
The average fiscal deficit for SEE6 declined in 2013 (Fig. 7 and 8). The deficit in Macedonia remains stable as a percentage of GDP. The increase in revenues is expected to lead to fiscal recovery in the region, remaining stable with an average 35.2 % of GDP.

Figure 7: Changes in revenues and expenditures, 2011-2012 (% of GDP)



Source: Eurostat

Figure 8: Changes in revenues and expenditures, 2012 and 2013 (% of GDP)



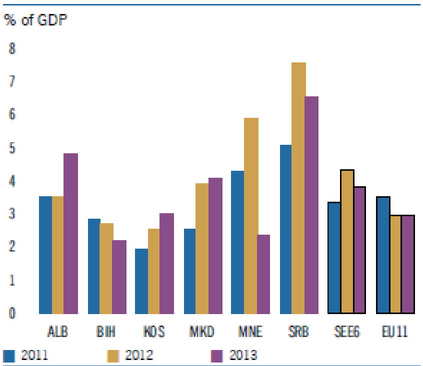
Source: Eurostat.

While fiscal deficits fell in 2013, the fiscal situation in SEE6 is not sustainable unless countries tackle structural rigidities in their expenditures[7]. On average, SEE6 countries reduced their fiscal deficits in 2013 thanks to tighter control of expenditures. The average unweighted fiscal deficit declined to 3.8 percent of GDP in

[7] World Bank (2013d), *World Development Report: Jobs*, World Bank, Washington, DC.

2013 from 4.3 percent of GDP in 2012 (Figure 9). With sluggish growth, deflationary pressures and the shift toward external demand driven growth, revenues came under pressure, falling by an average of 0.5 percent of GDP. But tighter spending, falling by 1 percent of GDP on average, more than compensated the revenue drop.

Figure 9: Fiscal Deficits

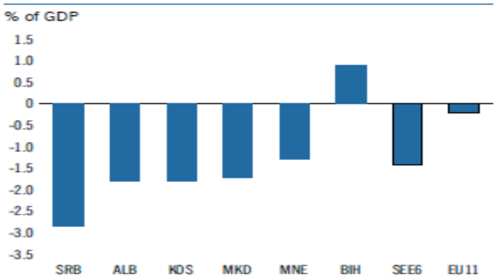


Source: World Bank staff calculations.

Most countries have seen declines in revenue as a share of GDP (Figure 10) and international trade taxes have performed especially badly. Receipts from international trade taxes declined by an average of 0.5 percent of GDP between 2009 and 2013, associated with shrinking imports (Figure 11)[8]. Albania and Montenegro were hit especially hard by falling VAT receipts, suffering declines by 0.5 percent of GDP and over 1 percent of GDP respectively relative to 2009 levels as a result of slow or negative economic growth. Only in Bosnia and Herzegovina did revenues increased slightly largely due to the success of the Indirect Tax Authority.

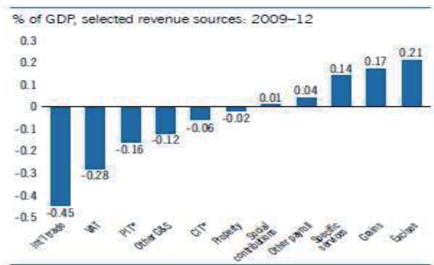
[8] World Bank (2013d), *World Development Report: Jobs*, World Bank, Washington, DC.

Figure 10: Change in Revenues, 2009–13



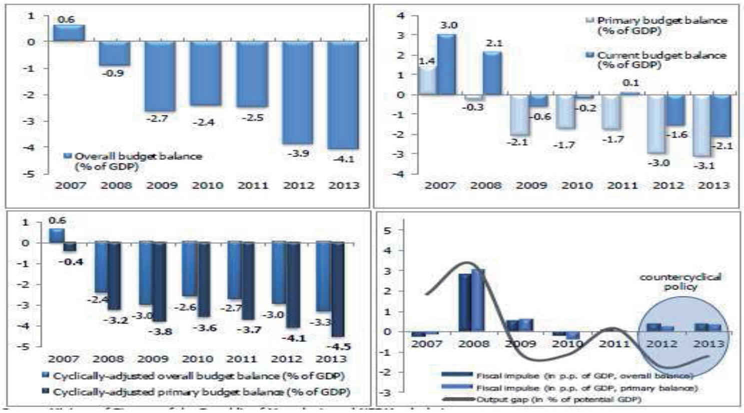
Source: World Bank staff calculations.

Figure 11: Average Contribution Towards Change in Revenues



Source: World Bank staff calculations.

Figure 12. Fiscal indicators for Macedonia



Source: Ministry of Finance of the Republic of the Macedonia and NBRM calculations.

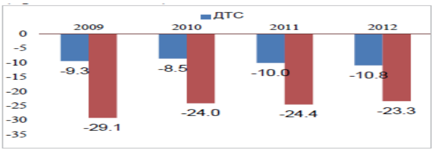
The analysis of the discretionary changes in the fiscal policy suggested further countercyclical policy. The total structural deficit increased to 4.5% from 4.1% in 2012, amid simultaneous increase also in the structural primary deficit from 3% in 2012 to 3.3% in 2013 (Figure 12)[9]. Consequently, as in 2012, a positive fiscal impetus was given, which, according to the structural primary balance was slightly higher than in 2012. If the analysis includes the output gap, than the fiscal policy was countercyclical also in 2013. Financing of the budget deficit on a net basis in 2013, was done through auctions of government securities, and the rest of the required net inflows was provided from external sources. Reports also showed that also in 2013 there was a trend of increased borrowing through government bonds versus the moderate reduction of the borrowing through Treasury bills.

Due to the close economic ties, external factor in SEE6 highly correlated with development of events in the EU. In 2012 SEE6 experienced a drop in trade, current account deficits, FDI and transfers. In the first quarter of 2013 exports is driven by FDI and the improved economic performance of the EU. While current account deficits and trade balances deteriorated in 2012, in the first quarter of 2013 they

[9] NBRM (2013), *Annual Report.*

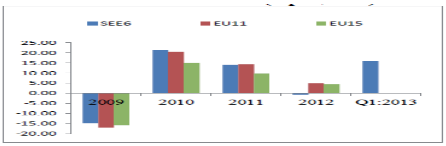
registered reverse. Reducing the demand for EU goods SEE6 led to a decline in the region which began in 2011 and continued in 2012 (Fig. 13 and 14).

Figure 13. Current account deficit and trade balance SEE6 (percentage of GDP)



Source: IMF, World Bank

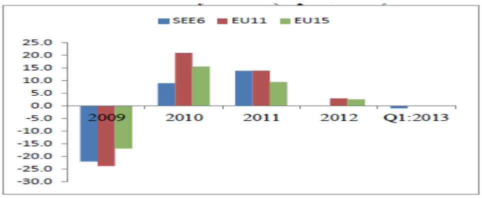
Figure 14. Export growth (%)



Source: IMF, World Bank

From the first quarter of 2013, exports are likely to improve in future for the entire region. Imports remained unchanged in 2012 and fell again in the first quarter of 2013. Movements in terms of trading, also play a major role in explaining the growth trends of imports through SEE6. Prices for energy imports fell sharply in 2009 and increased significantly in 2010, while in 2011 remained at the same level in 2012 and declined in 2013. In Macedonia, the imports in the second half of 2012 was falling faster, because domestic demand and industrial production continued to decline which is an example for the first quarter of 2013 too(Fig. 15), mainly due to weak domestic demand and economic activity.

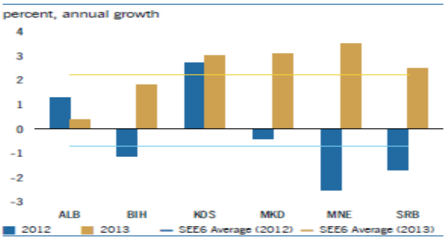
Figure 15. Import growth (%)



Source: IMF, World Bank

The SEE6 countries exited from recession in 2013 with economic growth supported by the recovery in high-income countries, particularly those in the European Union (EU). After a 0.7 percent decline in 2012, the average real GDP of SEE6 grew 2.2 percent in 2013 (Figure 16). All six SEE countries marked positive growth, with growth at or exceeding 3 percent in Kosovo, FYR Macedonia and Montenegro. Only in Albania did economic growth slow in 2013 compared to 2012, though it remained positive. External demand for SEE6 exports was the key driver of this growth recovery, reflecting an improving European and global economy.

Figure 16: Growth in SEE6, 2012–13



Source: National statistics offices, and World Bank staff estimates.

On the demand side, exports drove the economic recovery. The gradual recovery in the Euro Area helped goods exports of SEE6 expand by close to 17 percent (Table 1)[10]. Serbia's exports surged by 25.6 percent in 2013 compared to 2012. Merchandise

[10] World Bank (2012b): *Golden Growth, Restoring the lustre of the European economic model*, World Bank, Washington, DC.

exports grew across the region, from 2.8 percent in Montenegro to 13.4 percent in Albania, while services exports performed worse than merchandise exports.

Table 1: Growth of Goods Exports

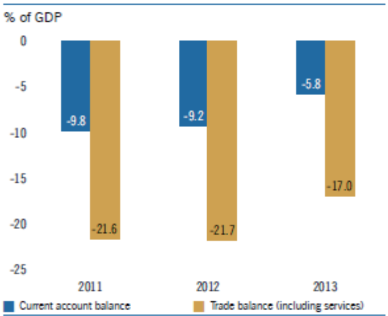
million, Euro

	2012	2013	change in %
ALB	1,526	1,731	13.4
BIH	2,582	2,807	8.7
KOS	287	305	6.3
MKD	3,107	3,206	3.2
MNE	392	403	2.8
SRB	8,726	10,956	25.6
SEE6	**16,620**	**19,408**	**16.8**

Source: World Bank staff estimates.

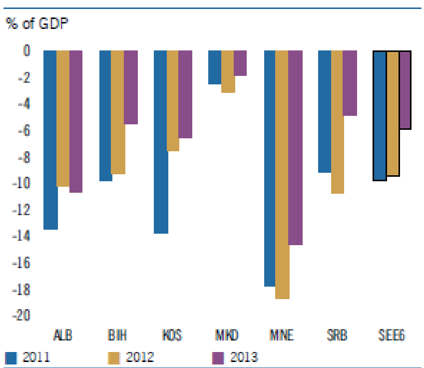
An export-led recovery combined with depressed domestic demand resulted in a significant narrowing of current account imbalances in all SEE6 countries. The increases in exports and the declines in imports lowered the trade deficit of SEE countries by 4.7 percent of GDP and the current account deficits by 3.4 percent of GDP in 2013 (Figure 17, Figure 18). Exports to the EU grew strongly, especially in Bosnia and Herzegovina, FYR Macedonia, and Serbia. Montenegro's and Kosovo's share of exports to the SEE region increased. Manufactured goods were the largest share of exports from SEE6 followed by machinery and transport equipment. Jointly they comprised over 60 percent of exports in 2013 in the region. The major increase in 2013 came from export of machinery and transport equipment from Serbia. Exports in FYR Macedonia grew also on the back of machinery and transport equipment as well as chemical materials. Mineral fuels exports were quite significant in Albania and Montenegro, while base metals were around a quarter of exports from Kosovo in 2013.

Figure 17: SEE6 Current Account and Trade & Service Balances



Source: Central banks, IMF WEO, and World Bank staff calculations.

Figure 18: SEE6 Countries' Current Account Balance



Source: SEE6 Central Banks.

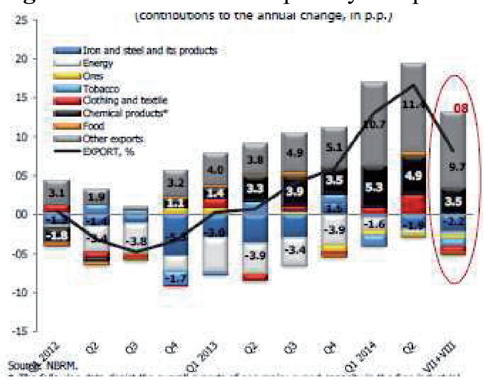
The reports by NBRM showed improved performance in the current account in 2013 due to the improved balance of goods and services, amid reduced net inflows in current transfers and higher net outflows in income[11]. The reduction in the trade deficit by 3 percentage points of GDP was mainly caused by a narrowing of the energy deficit, although the non-energy had the same, however significantly milder

[11] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

effect. The individual components of trade registered divergent movements. Exports, driven by the enhanced activity of the new capacities in the economy with foreign ownership, registered an annual growth of 3.2%, while the reduced demand for energy products and the annual decline in energy prices reduced the import component, causing an annual decline of 1.5%. Divergent movements in exports and imports caused stagnation of total foreign trade on annual basis.

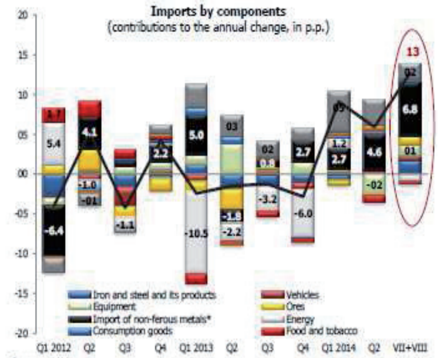
The exports of the companies from the industrial development zones were the most important driver of Macedonian exports in 2013, increasing their resilience, amid still unfavorable global conditions that caused a decrease in the exports of the metal industry. Also, increased exports of new companies were sufficient for offsetting the significant decline in the exported petroleum products, caused by the simultaneous reduction of the exported quantities and lower export prices.

Figure 19. Macedonian export by components



Source:NBRM

Figure 20. Macedonian imports by components



Source:NBRM

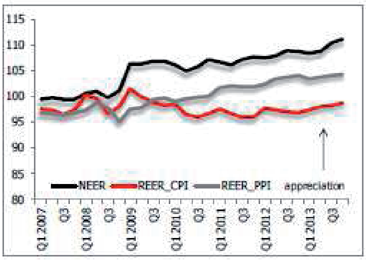
In the period from July to August 2014, the foreign trade deficit expanded by 22.4% on an annual basis, conditional on the faster annual growth of import relative to the growth of export activity.Macedonian exports during the second quarter in 2014 recorded an annual growth of 8.2%, and the increased use of new facilities remains a major factor of the positive changes in exports while all other categories acted in the opposite direction, with the largest decline being registered in the export of iron and steel (Fig.19)[12]. On the other side, Macedonian imports in the second quarter of 2014 reached an annual growth rate of 12.7% which was driven by the rising import of raw materials for the new export oriented facilities and metal industry versus the moderate annual decline observed in the energy imports (Figure 20). Larger downward deviations occurred in part of the traditional export products, i.e. exports of iron and steel, ores and tobacco, which is offset with the export activity of the new facilities.

Price competitiveness indicators of the Macedonian economy showed a negligible appreciation of the Denar in 2013. The CPI-deflated real effective exchange rate rose by 0.9%, while the PPI-deflated REER recorded an annual appreciation of 0.4%. The change was entirely caused by the movement of the nominal effective Denar exchange rate, as a result of the appreciation of the domestic currency against the

[12] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

Russian Ruble and Turkish Lira, with favorable slower movements of domestic relative to foreign prices.

Figure 21. NEER and REER (CPI and PPI, 2006=100)



Source:NBRM

Relative prices (2006=100)

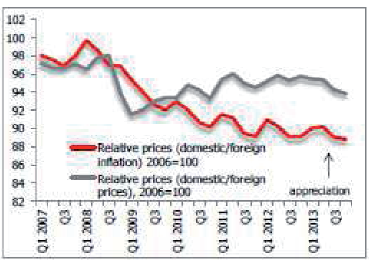
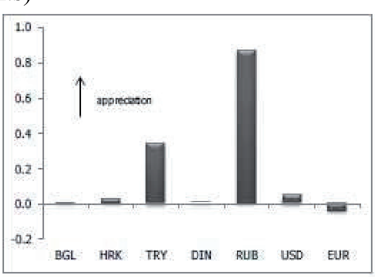
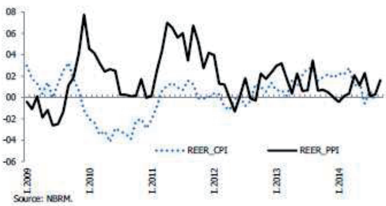


Figure 22. Contribution to the annual change of NEER of the Denar (in percentage points)



Source:NBRM

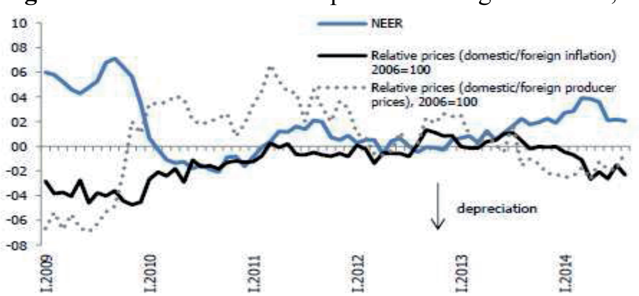
Figure 23.REER
annual changes, in %



Source: NBRM.

In August 2014, price competitiveness indicators of the domestic economy registered divergent movements on an annual level. Ehen this is compared with the same month of the 2013, the REER deflated by consumer prices depreciated by 0.3%, while the REER deflated by producer prices appreciated by 1.6% on an annual basis.

Figure 24. NEER and relative prices annual growth rates, in %



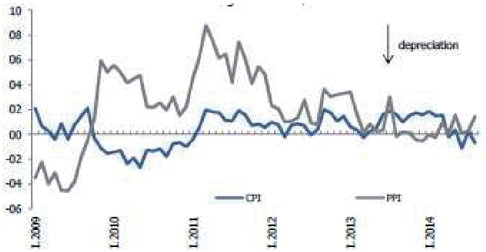
Source: NBRM.

Depreciation of the Ukrainian hryvnia, Russian ruble and Turkish lira against the denar had a influence for the further appreciation of the nominal effective exchange rate by 2% on an annual basis,and this caused upward pressures on both REER indices[13]. The growth of foreign consumer prices and as faster growth in foreign

[13] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

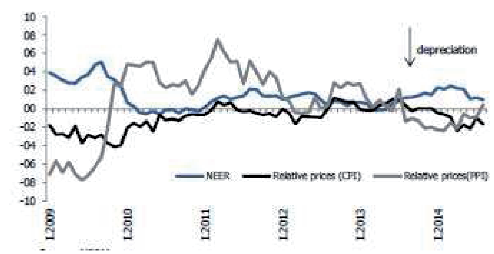
versus domestic prices of industrial products, led to a decline in relative prices by 2.3% and 0.4%.

Figure 25.REER, excluding primary commodities annual growth rates, in %



Source: NBRM.

Figure 26. NEER and relative prices, excluding primary commodities annual growth rates, in %



Source: NBRM

The movement of the REER , excluding primary commodities, indicates similar movements in the domestic price competitiveness. The REER deflated by producer prices appreciated by 1.5%, while the REER deflated by consumer prices depreciated by 0.7% on an annual basis. Figure 26 show that due to decline in domestic prices, relative CPI registered an annual decline of 1.7%. Also, relative prices of industrial products recorded a growth of 0.5%, driven by higher domestic prices. NEER appreciation continued in August 2014, annual change driven by the depreciation of the Turkish lira and the Serbian dinar against the denar.

Economic policies can be instrumental for growth in the near- and the medium-term in SEE6. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward investment and away from wages, public expenditure targeting and prioritization as well as improvements in revenue collection and the broadening of the tax base, among others. On the monetary policy side, with regional inflation at a very low 1.2 percent and big output gaps remaining, some scope for short-term easing of monetary conditions exist, especially in those countries where deficits have begun to decline.

However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restoring the growth of credit and supporting entrepreneurship and job creation.

4. Macedonian fulfillment of economic criteria: current situation

The EU agenda remains strategic priority for Macedonia. To cope with competitive pressures and market forces within the Union in the medium-term, the country needs to address important challenges through determined implementation of structural reforms. The economic recovery continued to progress, but it remains narrowly based on the external sector, and has had limited impact on unemployment which remains high especially among young people. Financial stability was preserved and FDI inflows increased. Fiscal discipline as well as transparency and quality of government spending deteriorated. Prospects for growth and employment depend largely on the business environment of the domestic private sector. A better alignment of workers' skills with labour demand needs to be tackled through further reforms of the education system, including the implementation of the vocation training strategy. Regarding public finances, the renewed deterioration of fiscal discipline in 2013 and 2014 calls for improved budget planning procedures and better consistency of annual budget execution with the medium-term fiscal strategy[14]. The quality of public spending should be improved, by shifting the composition of capital expenditure towards growth-enhancing investment. Monetary policy remained successful in defending the currency peg. The inflation environment remained benign, creating room for monetary policy to stimulate sluggish credit growth. The increase in the consumer price index (CPI) averaged 2.8 % in 2013, down by about 0.5 percentage points since 2012 and fell further in spring 2014, mainly due to declining prices for food and housing and utilities.

5. Macedonian challenges to EU accession?

The performances of the real convergence of Macedonia lag seriously compared with the new member states. Although GDP growth is accelerating in Macedonia in the past few years, in comparative perspective Macedonian inability to maintain rapid convergence of GDP per capita with EU countries, is a source of concern. Given low Macedonian GDP per capita, realizing real convergence in per capita income is increasingly important. Macedonia has suffered from regional instability and domestic disturbances, as other new members also faced with economic and financial crises.

The growth of capital stock is a key component of real convergence in the new Member States, because the ratio of investment to GDP is higher in the most of new member states, which ranges between 35% and 25% of GDP. The investment rate of Macedonia is on average less than 20% of GDP, which made the per capita income convergence with the EU impossible, through the growth of the capital stock. If Macedonia isn't able to increase the share of GDP and to devote at fixed capital formation over 25%, will be forced on fully devoting for productive gains, thus to be with the level of income per capita of other EU Member States. From reports about economic policy could be seen that In January 2014, the authorities submitted the eighth Pre-accession Economic Programme (PEP), outlining key economic, fiscal and structural reforms for the period 2014-2016. Its macroeconomic and fiscal framework

[14] World Bank (2013e): Western Balkans Activation and Smart Safety Nets AAA Synthesis Note, Mimeo,World Bank, Washington, DC.

is somewhat optimistic with gradually increasing growth averaging close to 4 %, driven by domestic demand, and a gradual reduction in the general government deficit ratio to 2.6 % in 2016.

Further efforts will be needed to improve the business environment, in particular market exit procedures and access to finance. The political consensus on the fundamentals of a market economy was maintained, but economic policy and public expenditure management remain driven by ad hoc concerns rather than the long-term requirements of the economy. Analyzing macroeconomic stability, the current account deficit narrowed in 2013 to 1.8 % of GDP, as the merchandise trade balance improved, and in spite of a drop in current transfers. In the same period, foreign direct investment (FDI) inflows strengthened– in 2013, they accounted for 3.5 % of GDP, and stayed at the same level in the first half of 2014. In 2015 is expected pick-up in export activity, when the new capacities are taking up operations. Output growth needs to be more broadly based, and external imbalances are likely to widen again temporarily in view of investment-related imports.

It is important to mention that many of the larger rates of the capital formation in the new member states is due to high levels of corporate savings and capital inflows, mainly in the form of FDI rather than result of high domestic personal savings. Thus, the low level of FDI in Macedonia are reason for short-term decline in capital formation.

Another barrier for investment - which carry growth - is domestic "investment deficit", which is mainly due to poor profitability and savings as the investment behavior of Macedonian companies too. Thus, the overcoming the low propensity for investing by the Macedonian firms is particularly important for real convergence. Macedonia differs from the new Member States not only because of its low level of capital formation but also because of its different dynamics of total factor productivity. In Macedonia, because of the capital accumulation there was minor contributions for development, changes in employment and growth in total factor productivity were the main driver of GDP growth, from one year to another. To formulate effective policy is necessary researching of the growth of total factor productivity in Macedonia, as well as the causes of low business investment.

The other elements of the structural convergence are the movement of labor and economic activities, generally from agriculture to industry and services. In all transition economies this structural change is ongoing process and it is a part of the international routes where all countries experience a shift in economic activity from agriculture to manufacturing and then from agriculture and manufacturing to the services, as the income per capita is increasing. Labour market conditions improved marginally, but remained challenging. The unemployment rate fell gradually, to 28.2 % in the second quarter of 2014, from an average of 29 % in 2013. Reforms to tackle the structural rigidities of the labour market have made only limited progress. The employability of workers should be improved through structural measures as well as through better targeting of the active labour market measures. Macedonian industrial value of added share is declining faster than in the case of new Member States, and in the case of Macedonia, this structural change occurs with little convergence in per capita income. EU Membership can improve the industrial situation in Macedonia only if the access largely makes Macedonia location from which foreign investors can serve the EU market if the domestic industry, with the help of FDI can take the necessary change for its output, an issue explored in greater detail in the section of the industry.

6. Nominal convergence of Macedonia

Nominal convergence is important not only for preferred rates of low inflation and macroeconomic stability, but also because the numerical targets for adopting the euro are set for inflation, interest rate and exchange rate stability.

The new Member States had inflation rates that are significantly higher than those of the Euro zone, and also higher than those of the less developed countries of EU. In all new Member States, the commitment to reduce the rate of inflation is a long process and mainly concern of the monetary authorities. In the early stage of transition and beyond, inflation is related to the transition process as the creation of markets, economic stabilization and the need for major restructuring of relative prices in the economy. In the case of Macedonia, request access to the EU for greater market liberalization and price rationalization, will also appear as a source of inflationary pressures. Stifling of these short-term transitional and related factors, which drive the inflation drive, the key forces at the time of accession of new member states are longer forces: real convergence, capital inflows and economic policy, in particular the choice of exchange rate regime and fiscal balance.

Perhaps the most important long-term drivers of inflation in the new member states is real convergence and consequently the Balassa-Samuelson effect, which implies that countries with a higher income have higher price levels and real convergence must therefore lead to price convergence through higher inflation rates in countries that have "captured" step. Other factors, such as growth of domestic demand, especially consumer demand driven by rapid credit expansion, high real interest rates attract foreign capital and a fixed exchange rate, contributing to higher inflation. Some new Member States that have flexible exchange rates were only able to mitigate the effects of domestic inflation through nominal appreciation. New EU member states with flexible exchange rates do not have much time as is expected in conducting independent monetary policy due to large capital inflows. Countries with fixed exchange rates have the same space for a nominal appreciation, but they are facing with problems in implementing an independent monetary policy and sterilization high costs as dangers of overheating of low real interest rates. They also remain specific countries with specific sources of inflation, as prices for achieving energy and utilities, with their costs of production.

Given the large gap in prices and income per capita between Macedonia and the EU, accepting the price will be an important source of inflationary pressure, also facing the existing price distortions in the energy, municipal services, pre-access can move this inflationary factor as a driver for access later, around the time when the effect of real convergence on inflation is combined with the negative short-term effects of EU accession on fiscal balance, falling interest rates and so on. This will require careful management of the exchange rate and will complicate efforts for Macedonia in meeting the Maastricht criteria for inflation.

Taking in view the political implications of convergence, the new Member States use different macroeconomic policies to bring their economies up to the level where they would be ready for access. The experience of transition economies suggests that monetary policy has limited effectiveness: the ratio of credit to GDP is low, household funds are low and households lending is relatively underdeveloped, so that interest rate changes and changes in credit availability have a relatively small effect on household consumption.

The banking sector is concentrated and larger banks are relatively strong and well supplied also reducing sensitivity of the economy to monetary instruments. All of these considerations apply to the financial system in Macedonia. Fiscal policy also has limited effectiveness because of high marginal propensity to import, which means that fiscal policy has a lesser effect on domestic output and proportionately larger the current account. The automatic stabilizers are weak because of the high reliance on indirect taxes and the benefits of low unemployment. Macedonia has maintained a conservative fiscal stance and low inflation, but pressure from the salaries of the public sector, the growing demand for public services, the infrastructure needs, pensions and administrative costs for EU accession, they will make a request for budgetary expenditures, thus putting more stress on fiscal and monetary policy.

Another important area where the new EU member states have introduced important reforms is to strengthen the use of information technology - and of reforms - functions of government. These measures have the potential to reduce costs while simultaneously improving the control of government expenditure and revenue and accelerate the flow of funds and information on the implementation of fiscal policy. Macedonia has made numerous improvements in this area, especially with the rationalization of health services and other fees imposed for payment. However, the government should continue to follow best practices in other countries with rising grounds. Decentralization of the government spending in Macedonia, and the need to use EU funds effectively will require Macedonia to show itself able in demonstrating best practice standards in the area of budget management. Macedonia is faced with a need to cut the expenses for administration. Such opportunities will be critical in obtaining all available EU funds. Total public debt stands at close to 50 % of GDP, and is likely to rise further in the short- to mid-term, given the considerable financing needs related to plan investment projects. The continued increase in the levels of government and public debt gives rise to concern about its long-term sustainability. The government needs to take steps to stabilize debt levels.

7. Convergence in terms of a fixed exchange rate regime

In terms of macroeconomic convergence, EU membership requires convergence of the Macedonian economy with that of the EU, in the context of realistic conditions - indicating per capita income and economic structure and nominal terms - indicating convergence of prices, inflation rates and interest rates.

-Fiscal effects of accession

Strengthening the absorption capacity for using EU funds has big importance in order to get all available support in the pre-accession period before entering the EU.

Also, preparation and simulation of financial flows between Macedonia and the EU budget before and after accession period has big importance in acquiring orientation magnitude of flows, as well as strengthening the administrative absorption capacity for using EU funds. This process should include activities aimed at increasing the capacity to prepare projects and activities aimed at strengthening the institutions and procedures that are necessary for effective absorption of EU funds. There is need of NGOs, schools, universities and individuals to help in developing the capacity for implementation and use of EU funds. Fiscal discipline and the quality of public spending deteriorated further in 2013 and 2014. In both years, the government was again forced to adopt a supplementary budget due to pressures arising from revenue shortfalls and repayment of accumulated arrears owed to private companies in the first half of the year. The government's medium-term strategy for 2014-2016 foresees a gradually declining general government deficit, to reach 2.6 % in 2016. Fiscal discipline needs to be improved, and there is significant scope for enhancing fiscal transparency. The government's fiscal consolidation plans need to be underpinned by concrete measures.

-Industry and non-financial services

One of the conditions for Macedonia is to realize faster growth of GDP of the major investments and major engagements with the world economy, especially with neighboring countries in Southeast Europe and the EU. This may be the preference towards market-friendly reforms in improving business environment and attracting more FDI. The Macedonian industry and industrial exports are less diversified than those of many small new member states and Macedonia should promote diversification.

Macedonia needs to support the modernization and upgrading of its main established sectors such as textiles and metal products. Subsidies or state aid should improve the competitive environment. Macedonian industry must beef up research to strengthen Macedonia's ability of using and adapting new technology. Strengthening the capacity is reflected in the restructuring of infrastructure costs for transport, because statistics show their increased role. Also, there are reforms of the Macedonian Government which are focused on developing tourism and attracting foreign tourists, something that everyone receives. Prepared formal plans for tourism development are achieved as their implementation too. Macedonia is well positioned as a safe and attractive destination, with improved infrastructure and services used by tourists, including hotels, restaurants, historical monuments, natural reserves, gradually making the country more accessible to visitors, particularly for aviation where relationships are rather limited.

-Agriculture

This segment is an issue that particularly affects Macedonia. The most important constraints which are facing the Macedonian agriculture and rural development are wider structural problems in the market of final goods and services and rural market as a factor. Thus, given a number of recommendations relating to the comprehensiveness of policies in this sector, and the implementation of EU standards for quality and phytosanitary standards, ensure the EU integration.

-Financial Services and capital flows

Policymakers should prepare for pressures of real convergence in accordance with EU membership. If there is pressure on the real appreciation or revaluation current leaving de facto peg in service of fluctuating exchange rates should be considered too.

Also, it is necessary to strengthen the regulatory and supervisory forces for macroeconomic stabilization and limit the risk of credit boom and crisis, as well as monitoring and discouraging foreign currency loans to households. It is necessary to regulate the cost of customer acquisition through insurance and pension funds and efficiency in administration. Next recommendation from the experiences of other countries, is creating a framework that will provide an opportunity for analysis, regulation and supervision of the financial system in a comprehensive manner, as uprising Supervisory structure that will integrate all financial sectors in Macedonia together with the Central Bank. Macedonian banking-sector regulator should develop a comprehensive framework for the regulation of the liquidity management of local banks, including tools for potential restrictions on cross-border liquidity during the instability.

For structured business environment is considered to hold an average level according to the analysis, in terms of overall assessment. Government is making efforts to improve the Macedonian attraction for foreign investment in the past few years. Macedonia has improved in terms of regulatory quality, business freedom, trade freedom and the financial sector. In practice many shortcomings continue to hamper business operations, i.e. areas with specific weaknesses which include excess bureaucracy, corruption and a weak significant protection of their rights. The development of the domestic economy depends on building better linkages between foreign investment companies and local businesses which, in turn, requires government and local businesses to work on better skills-matching and investment in higher-productivity activities. Improvements in market entry and exit would also help.

-Taking in view market entry and exit and the free economic zones, domestic companies do not enjoy a level playing field with foreign companies as regards incentives. Conditions for obtaining public support implicitly favour (bigger) foreign firms, as local firms can rarely meet the required investment size. Government arrears still pose a problem for business' liquidity, despite the recently tightened legal requirements. Overall, while setting up a business has become slightly easier, difficulties remain as regards obtaining permits. Market exit remains lengthy, although the government has taken some reform steps in the right direction.

-Financial sector development

The country's financial system is dominated by the banking sector, about 89 % of the system's total assets, while the insurance sector, including fully-funded pensions, represents roughly 4 % of total assets. Macedonian banking sector is seen as healthy, according to the IMF. The size of banks' financial intermediation is important, with the assets-to-GDP ratio having risen gradually over recent years to about 80 % by the end of the first quarter 2014.

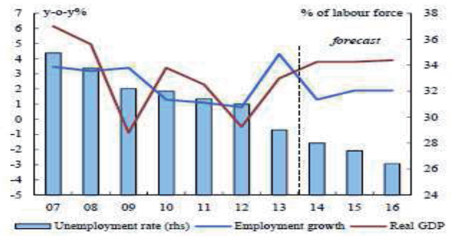
The financial system remains stable, and supervisory capacities have been further strengthened. However, access to finance continues to be difficult, and the non-banking segments of the market need to be further developed, with a view to widening funding opportunities for the private sector. Measures should continue to be taken to repair the bank lending channel, including by fostering the clean-up of non-performing loan portfolios.

8.Expectation and dynamics of economic development for Macedonia (2014-2015)

What was characteristic for Macedonian economy in 2014? Output growth in Macedonia accelerated in 2014, driven by exports of foreign investors and public infrastructure investment. Solid gains in household spending further bolstered domestic demand. Given high investment- and trade-related import demand, the foreign balance weighed down on economic activity. Further gains in domestic demand are likely to set GDP growth at an even higher pace in 2015 and 2016, while the negative contribution from net exports is expected to diminish. Actually in 2014 exports and investment were the main drivers of growth. Large-scale public infrastructure projects and a surge in exports, mainly driven by foreign companies established in the country, carried the marked acceleration of real GDP growth in 2014. Given the high import content of investment and exports, the external balance made a negative contribution to growth, after having been its main support in 2013. Strong increases in overall gross fixed capital formation in the first three quarters of 2014 were followed by slack towards the end of the year, yet, on average, investment activity recovered markedly after its sharp drop in the preceding year. As of the second quarter, household spending, supported by rising real net wages, stable private transfer inflows and improved access to credit, turned into a solid second pillar of domestic demand growth. The merchandise trade balance improved in 2014, in terms of GDP, compared to the previous year. This, in combination with an increased surplus in the services balance, and stable private transfer inflows, accounted for a narrowing in the current account deficit, by 0.5 pps. to 1.3% of GDP.

Another concerning fact was that fiscal performance disappointed further in the second half of 2014. At the end of the year, the general government deficit amounted to 4.2% of GDP, exceeding the revised target by 0.5 pps. The increase in government debt remained contained in 2014, but borrowing by state-owned enterprises drove up public debt levels as well as contingent liabilities of the government, which provides guarantees for their loans.

Figure 27:Labour market in Macedonia



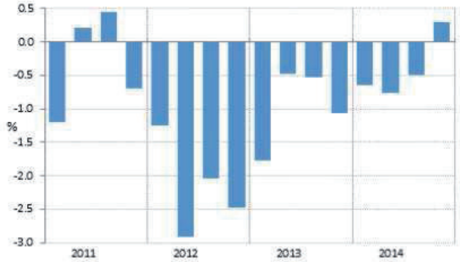
When the attention is on the investment activity, than driven by public expenditure on transport and energy projects, as well as the construction of new foreign investment facilities, is projected to post further solid gains, even though growth rates are slowing down to their long-term average. Household spending, benefitting from sound fundamentals, is likely to firm up further, and set to become the main source of output growth in 2015 and 2016. Export performance is projected to remain solid, mainly driven by foreign exporters which are putting new production lines in operation. With investment-related imports relenting somewhat, the merchandise trade balance is likely to improve slightly this year and next, mitigating the negative contribution to GDP growth from the external balance. Still, the current account deficit is set to widen somewhat, largely accounted for by an expected normalisation of private transfer inflows to more moderate, average levels. Public expenditure continues to support domestic demand in Macedonia. This means that the government is expected to continue providing a positive fiscal impulse to domestic demand this year and next, by further increasing social transfers, pensions, and public wages. At the same time, significant budget funds, and financing by state-owned enterprises, are earmarked for further public infrastructure investment. The recent and envisaged increases in entitlement spending are already leaving their mark on budget performance - in the first two months of 2015, the accumulated budget deficit amounted to some 25% of the full-year budget target, or 0.8% of projected GDP.

9.Aspects of the effects of external factor changes and dynamic of economic development: the case of Croatia

Croatia remained in a recession in 2014 and GDP declined by 0.4 percent, although a mild recovery is forecasted for 2015. Domestic demand is still suppressed amid weak labor market developments, household deleveraging, delayed investment decisions, and negative market expectations. The most negative contribution to growth came from a decline in construction, while industrial production, retail trade, and tourism finally registered growth in 2014. The long recession kept the unemployment rate at 17 percent in 2014, despite strong support from active labor market policies. Yet, a mild recovery is forecast for 2015, spurred by European Union (EU)-funded investments. As the absorption of EU funds strengthens in 2015, investments in research and development (R&D) and public infrastructure are expected to turn positive, hopefully generating jobs for the large pool of unemployed construction workers. Real GDP growth is expected to gradually strengthen from 0.5 in 2015 to 1.5 percent in 2017.

Fiscal consolidation efforts slowed in 2014. The fiscal deficit remained above 5.5 percent of GDP in 2014 (up from 5.2 percent in 2013). Public debt reached 80 percent of GDP in 2014 and external debt remained high at 108 percent of GDP. The EC had already expressed concerns about the net international investment position, losses in the market share of exports, and the rise in and persistent high level of public debt and the unemployment rate. To complement fiscal consolidation efforts, the authorities are conducting a spending review process for health, subsidies, the wage bill, tax expenditures, and public sector agencies to identify 10 percent cuts in spending.

Figure 28.GDP Growth

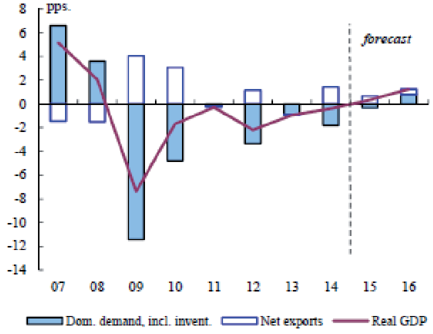


Source:Croatian Bureau of Statistics (CBS).

Reflecting subdued domestic demand but growing interest payments and a decline in workers' remittances, the current account remained in surplus but declined slightly to 0.1 percent of GDP. The trade deficit narrowed to 15.4 percent of GDP, reflecting growing exports to the EU and lower oil prices. Deleveraging by parent banks continued and foreign direct investment (FDI) tripled compared to one year ago. Due to its reliance on volatile capital flows and high public and private sector indebtedness, Croatia remains vulnerable to financial market volatility. Progress in addressing inactivity and unemployment as the main cause of the recent rise in poverty remains slow. Addressing fiscal vulnerability and existing social challenges requires faster implementation of structural reforms.

In 2015 economic growth in Croatia is set to creep into positive territory in 2015, thanks to external demand. The forecast for 2016 is that growth should accelerate to just above 1%, as investments are expected to lead a mild recovery of internal demand. Employment nevertheless is set to stagnate, while the need for further consolidation of public finances in 2016 will weigh on Croatia's fragile growth. Croatia's economy is expected to grow in 2015 at a modest rate of 0.3%. The marginal upward revision of 0.1 pp. since the previous forecast is attributable to the improved growth prospects inCroatia's trading partners, partially offset by additional fiscal consolidation measures. Internal demand is expected to detract from growth for one more year, though the pace of the contraction should gradually abate to -0.3%. Low absorption of EU funds, on-going deleveraging pressures and weak private demand are set to still hold back investment activity in 2015. Despite continuing weak labour market performance, the contraction in private consumption is set to come to an end in 2015, thanks to the positive impact of reforms to personal income taxation and lower oil prices. Employment is set to stagnate in 2015, while the mild reduction of the unemployment rate to 17% will be driven by a reduction in the labour force. Exports are expected to grow by 3.7%, driven by improved cost-competitiveness and especially the acceleration of the recovery in the rest of the EU. On the back of weak internal demand, imports are expected to grow at a moderate pace of 2.4%, thus increasing Croatia's current-account surplus. In 2015, price dynamics are expected to be almost flat, as opposed to the winter forecast, due to the earlier-than-expected recovery in energy prices. Core inflation is expected to remain subdued due to weak demand.

Figure 29.Croatia – Real GDP growth and contributions



Growth is set to pick-up somewhat to 1.2% in 2016, as the contraction in all domestic demand components is expected to come to an end. Investment, in particular, is set to rebound as a result of increased absorption of EU structural and investment funds and improving expectations. Net external demand should continue contributing positively to GDP growth, though more moderately, as imports are set to accelerate. A slight increase in employment, in a context of a stable labour force, should result in a mild contraction of the unemployment rate to 16.6% in 2016. Risks to this forecast scenario are mainly tilted to the downside, as additional consolidation measures, necessary to rein in public finances and bring the general government debt on a sustainable path, could dampen from growth in 2016.

The general government deficit was 5.7% of GDP in 2014, compared to 5.4% in 2013. The slight deterioration was mostly caused by a decline of tax revenue, which more than offset an increase of social contributions due to the change of health contributions rate. Both indirect and direct tax revenues declined in 2014 reflecting the continually weak domestic economic activity. On the other hand, although expenditure increased only slightly, underlying developments of individual components were quite different; higher spending in social transfers and intermediate consumption was offset by lower expenditure on wages and subsidies.

In 2016, the deficit is forecast to remain broadly unchanged, in spite of the moderate pick-up in growth. After having attained -4.0% of GDP in 2014, the structural deficit is therefore forecast to deteriorate only mildly in 2015 and more significantly in 2016 (-0.2 and -0.5 pps. respectively). The ratio of general government debt to GDP grew by 4.5 pps. of GDP in 2014 to reach 85% at the end of the year. This was essentially the result of the budget deficit and minor stock adjustments in the environment of low nominal growth. In 2015 and 2016, public debt is forecast to rise further to above 90% of GDP mainly as a result of underlying deficit trends.

In addition, our focus on Croatia could be sublimated in three parts for 2015:

First part is the macroeconomic situation which show excessive imbalances requiring decisive policy action and specific monitoring:

- ✓ Weak competitiveness and export performances
- ✓ Cumbersome business environment
- ✓ Poorly functioning labour market
- ✓ Increasing public debt

The second part is the progress on country specific recommendations:

✓ Substantial progress in diagnosis exercise on banks.

✓ Some progress in addressing labour market weaknesses and reforming tax and benefits.

✓ Limited progress in budgetary measures, public administration reform, retirement and pension rules, business environment, public property management and commercial courts.

And the last one is the fiscal situation which is caracterized by:

- ✓ Excessive deficit, deadline for correction 2016
- ✓ Public debt above the 60% of GDP threshold

10. Croatia and benefits of European Union Membership

For Croatia, EU membership brings opportunities and challenges as:

-improved access to a market of 500 million people, enabling Croatia to benefit from the flow of labor and capital and from new information and technology transfers;

-access to EU Structural and Cohesion Funds in excess of €1.8 billion a year (these funds present a remarkable opportunity to address Croatia's needs in transport and the environment as well as in innovation and the modernization of production);

-membership brings with it the serious challenges of aligning strategies and policies to absorb and manage the allocated EU funds.

A major challenge for the coming two–three years will be to secure enough funds from the state budget to absorb EU funds and avoid being a net contributor to the EU. As seen from the experience of other new member states, many governments have been successful in developing the necessary documents to secure funds from the EC, but weaknesses in implementation often limit their usage.

In this way, the Croatian economy is less competitive than that of its peers. To achieve private sector–led growth and faster EU convergence, actions are needed to liberalize the labor market and jump start enterprise restructuring. In recent years, Croatia's progress on improving the business environment for the private sector has been partial. Croatia has achieved substantial progress on improving efficiency, reducing the court case backlog, and increasing the accountability and transparency of the judicial system, all important factors for doing business. During the past year, the Government has taken some steps to facilitate the creation of jobs in the private sector. To address some of these challenges, the World Bank worked closely with the Government in many areas.

Also, Croatia has accepted a joint initiative to participate in the SEE 2020 strategy process, endorsed by the Commission, together with other participants, i.e. Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro and Serbia. The strategy has been developed along the lines of the EU 2020strategy.[15] The main concept of SEE 2020 is similar to that of EU 2020 and is based on five pillars of economic growth (smart, sustainable, inclusive and integrated growth and governance for growth), covering a total of sixteen areas. In short, the main targets of SEE 2020 are:

-to increase GDP per capita to 44% of the EU average;

-to more than double the total value of trade in goods and services relative to that in 2010 (the targeted value is 209.5 billion euros); and

-to narrow the trade balance deficit to 12.3% of GDP.

As an EU Member State, Croatia has free access to the European Single Market and it can use the potential of the available regional market. The macroeconomic environment and growth dynamics in the region are largely determined by the fact that trade with the EU accounts for 60% of its total trade and that Croatia and Serbia jointly account for 60% of the region's GDP.[16] While within the EU, Croatia constantly has to catch up with developed Member States, within the SEE 2020, it should be a leader and promoter of the region's economic growth and competitiveness.

Croatia is in a specific situation, which made it possible for the country to formulate sixteen headline targets and a number of reform measures and development priorities. The country's performance on the EU 2020 headline targets is currently satisfactory. After a one-year implementation of the strategy, Croatia's rankings on the employment, R&D, poverty and (partly) education targets (higher education) are

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[15] The purpose of SEE 2020 is economic cooperation among countries in the region, aimed at increasing competitiveness and achieving higher levels of growth, as well as facilitating social and institutional development through the adoption of reform policies. The expected outcome is a long-term acceleration of effective convergence towards the EU and increased preparedness for future EU membership negotiations. By joining this initiative, Croatia will be able to share its experience in establishing and adaptation of institutions necessary for active participation in the international strategic and EU accession processes.

[16] Regional Cooperation Council, 2014

worse than those of most other Member States. Nevertheless, its position with respect to environmental protection and energy efficiency and, partly, education targets has relatively improved. The implementation of EU 2020 is much more demanding for Croatia than that of SEE 2020, because the obligatory participation in the former strategy involves regular reporting on performance in meeting the headline targets, but also on the fiscal and macroeconomic indicators within the Excessive Deficit Procedure and Macroeconomic Imbalances Procedure. Consequently, Croatia's overall performance in the implementation of the EU 2020 strategy will be shown only in the next medium-term period.

The Government should formulate a national development strategy for the period until 2020, which is the next EU strategy cycle, thus synchronizing it with EU 2020 and SEE 2020, i.e. with the EU's new multiannual financial framework and financial period for the use of EU funds (2014-2020). This document should include all current goals, priorities and activities arising from the EU strategic processes, especially EU 2020, which should be integrated with Croatia's own strategic development priorities in areas further elaborated under the sectoral strategies. The national development strategy, once formulated, may have a positive influence on the mutual alignment of existing sectoral strategy documents and sectoral policy coordination, and, given an efficient implementation monitoring system, on the achievement of the set targets as well.

11. What factors will likely drive the economic convergence machine in SEE6 in 2015? Is there convergence projection for SEE6 and Macedonia in 2015?

The SEE6 region as a whole is projected to grow 1.3 percent in 2015, supported by a slowly recovering external demand, especially in Europe, and stabilization of international energy prices at around current levels. In the base line scenario, external demand will remain a key driver of growth in support of SEE6 industrial activity and export growth. Domestic demand in SEE6 is likely to remain subdued amidst weak consumer and business confidence and despite lower oil prices and household and government efforts to rebuild after the recent floods. Confidence will be dampened by lingering political uncertainty, chronically high unemployment, weak business climate, and banking systems saddled with high nonperforming loans. SEE labor market performance is likely to worsen (or at best remain stagnant) as the 2014 growth slowdown in Serbia and Bosnia and Herzegovina will likely be reflected in labor market outcomes with some lag. In contrast, marginal improvements in the employment rate in the faster growing SEE6 can be expected. Fiscal consolidation efforts are set to continue in 2015 in SEE6, with the exception of Montenegro where the start of a highway construction project will widen considerably the fiscal deficit. On the external side, the current account balances of the SEE6 are likely to stabilize at around current levels, as expected increases in external demand for SEE6 exports are largely offset by rising imports in support of domestic demand.

Growth is expected to be positive throughout the SEE6 with the exception of Serbia. Serbia is likely to remain in recession amidst weak domestic demand and difficult fiscal consolidation. Bosnia and Herzegovina is likely to start a gradual recovery. Albania, Kosovo, FYR Macedonia and Montenegro are expected to grow above 3 percent in 2015. The SEE6 growth forecasts carry downside risks. The key risks include:

1. the effects of the ongoing and planned fiscal consolidation and privatization programs could adversely impact public support for reforms;
2. the risk of deflation may continue to put downside pressures on growth;
3. poor economic performance in the Eurozone would limit external demand for SEE exports and financing availability to SEE6 countries;
4. given their strong ties with the EU and Russia, the SEE6 economies are vulnerable to the effects of potentially intensifying geopolitical tensions stemming from the Russia-Ukraine crisis; and
5. the region has shown high vulnerability to adverse weather conditions. On the positive side, low oil prices may help to boost growth and reduce current account deficits.

Structural challenges continue to hold back potential growth in SEE6. The functioning of the labor markets across the region is anemic with persistently high unemployment rates, low labor force participation rates, and sluggish formal job creation. Even though some progress has been made in easing the burdens of the investment climate, there is still room for improvement. The public sector is large and inefficient in many countries in the region. For all countries, investment in improved, wellmaintained, and/or upgraded capital stocks would help to replace the current obsolete infrastructure and help to boost economic potential, provided such investments are with positive economic returns and do not threaten the sustainability of public debt. Improved connectivity of the SEE6 region through physical and institutional linkages among the SEE6, to the EU, and to the rest of the world, will help competitive SEE6 firms reach new markets and foreign investors brought to the region. Advancement in the EU accession process represents an opportunity for the SEE6 to pursue a EU integration agenda also with a positive impact on potential growth. Economic growth in the near- and the medium-term in SEE6 can be supported through sound and well-prioritized economic policies that will tackle these structural impediments.

The SEE6 region as a whole is projected to grow by 1.3 percent in 2015, supported by a slowly recovering external demand, especially in Europe, and stabilization of international energy prices at around current levels. Potential output growth remains limited by structural challenges. The functioning of the labor markets across the region is anemic with persistently high unemployment rates, low labor force participation rates, and sluggish formal job creation. Even though some progress has been made in easing the burdens of the investment climate, there is still room for improvement. The public sector is large and inefficient in many countries in the region. For all countries, investment in improved, wellmaintained, and/or upgraded capital stocks would help to replace the current obsolete infrastructure in the region and help to boost economic potential, provided such investments are with positive economic returns and do not threaten the sustainability of public debt.

Improved connectivity of the SEE6 region through physical and institutional linkages within the countries, to the EU, and to the rest of the world, will help competitive SEE6 firms reach new markets and foreign investors brought to the region. Advancement in the EU accession process represents an opportunity for the SEE6 to pursue an EU integration agenda also with a positive impact on potential growth. Therefore, economic growth in the nearand the medium-term in SEE6 can be supported through sound and well prioritized economic policies to tackle these structural impediments. On the fiscal side, sustained reform effort is needed to address structural rigidities in the budgets of SEE6. Priorities include: changes in the composition of public expenditure toward productive investment and away from wages; public expenditure targeting and prioritization; arrears clearance; improvements in revenue collection; broadening of the tax base while reducing the labor tax wedge, among others. On the monetary policy side, with regional inflation at a low levels and still remaining output gaps in almost all SEE6 economies, some scope for short-term easing of monetary conditions exists, especially in those countries where deficits have begun to decline. However, caution needs to be exercised in the economies with flexible exchange rates to ensure that these do not come under pressure. The room for monetary policy easing is further limited, as policy rates are already low by historical standards and foreigncurrency denominated debt is high. In terms of financial sector policies, addressing the high NPLs would be critical to ultimately restore the growth of credit and support entrepreneurship and job creation.

The main goal of National Bank of Republic of Macedonia is the maintenance of the price stability.In this way, the National Bank is committed to applying strategy of maintaining stable nominal exchange rate against the Euro. The role of the exchange rate as a nominal anchor derives from the characteristics of the domestic economy, as a small and open economy that is highly dependent on the import of primary commodities. Also, Macedonian exchange rate can be used as an instrument for export performances of the country.

Macedonian policymakers should create policy with several aims focused on exchange rate policy because:

- A competitive real exchange rate provides an incentive for exports
- The impact of exchange rates on trade should be seen in the context of continued integration of supply chains
- Exports generally include high import content and impact of foreign currency-exchange appreciation or depreciation on any finished product because it is complex. If the depreciation of the exchange rate makes its exports of finished products "cheaper", it makes imported components "expensive" for domestic producers.
- Maintaining growth and reducing the unemployment in a small and open economy such as Macedonia depends from improved performance of exports.

- Improving the performance of exports can help to preserve macroeconomic stability by closing the gap in the current account to avoid wasting supplies and to stop the growth of external debt.
- Improving performance requires improving export competitiveness.
- An outward oriented, market-friendly trade regime, which emphasizes the dismantling of import controls and tariffs (permitting access to inputs at world prices), and streamlined bureaucratic procedures, *i.e.* export and import procedures, modern customs administration and efficient value added tax administration will facilitate exports, including from SMEs.

According to the expectations from reports by NBRM, the inflation will slow down also in 2015, when it will approach the historical average and equal 2%. Also, in 2015, it is expected that the current public investments will continue, and as there are expectations for new infrastructure projects.[17] It is estimated that these developments in the export sector and the strengthening of investment activity will create positive transmission effects on both the labor market and the expectations, and thus be a factor for further increase in the household consumption. It is expected that the GDP growth in 2015 it would speed up even more and reach 4.4%. Given the high openness of the economy, the risks to the projected growth continued to result from the global environment and developments in the external environment.

By the end of 2015, the credit growth is projected to accelerate and it would reach 8.5%. Projections for 2015 show that the external position can provide further increase in the foreign reserves and their maintenance at appropriate level. In addition, in 2015, widening of the current account deficit by 5.7% of GDP is expected, mainly due to the fall in private transfers.Despite the moderate deterioration on the current account, it is estimated that its negative balance will be fully financed by capital inflows, mainly coming from foreign direct investment and external borrowings for infrastructure projects. It is expected that the foreign direct investments will gradually increase in 2015 at 4.5% of GDP, respectively.

In 2015, prudent fiscal policy is expected, with gradual consolidation of the budget deficit and relatively stable level of public debt. The fiscal policy is important

[17] NBRM (2014) *Recent Macroeconomic Indicators* ,Review of the Current Situation.

factor that influence the monetary policy setup, while the adequate coordination of these policies is crucial for creation and maintenance of the macroeconomic stability. After the risen level in 2013, the budget deficit is expected to fall gradually and it would range about 3% of GDP on a medium run. Hence, in 2015, it would equal 3.2% of the GDP. The primary budget deficit should be equal 2.2% of the GDP in 2015, respectively.

There are significant downside risks to the macroeconomic outlook for the SEE6 region. These risks, both external and internal, are related to[18]:

- Deflationary risks in the Euro Area leading to weak Euro Area economic recovery:
- The pace of the Euro Area recovery could be weaker owing to disinflation or even deflation. This would reduce the export growth that has been so important to the nascent economic recovery of SEE6 countries.
- The pace of rising global interest rates: In light of the gradual tapering by the United States Federal Reserve, developing and emerging market economies, including the SEE6, are entering a period of expected global financial tightening in the medium term. This could have implications for funding inflows to the region.
- The potential geo-political ramifications of the ongoing Russia-Ukraine conflict:
- The escalation of the political crisis will introduce new risks for Europe. While the SEE6 linkages with Russia and Ukraine are limited, further intensification of these geo-political tensions would have inevitable direct (through trade and financial channels) and indirect (though second-round effects via Europe) implications for economic growth in the SEE6 region. Broader risks related to contagion and negative investor confidence may also appear as a result of the Russia-Ukraine conflict.
- Insufficient effort in tackling remaining structural weaknesses: “Reform fatigue” may delay implementation of policies designed to improve, for example, the business climate or address weaknesses in labor markets or reduce the large structural fiscal deficit or restructure the state-owned enterprise sector. In addition, the fiscal challenges to stabilize and reduce public debt in several countries may appear

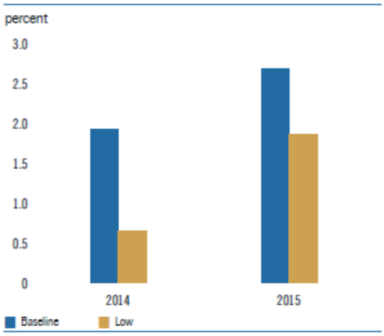
[18] World Bank (2013e): Western Balkans Activation and Smart Safety Nets AAA Synthesis Note, Mimeo, World Bank, Washington, DC.

daunting. Also, lack of progress on the resolution of NPLs, and public sector arrears to suppliers could adversely impact credit recovery and growth prospects.

- Socio-political tensions: Albeit to a different degree across the SEE6, high levels of unemployment, ongoing SOE restructuring efforts and elections in Bosnia and Herzegovina and Kosovo are among the factors which may trigger heightened social tensions, as seen most recently in Bosnia and Herzegovina.
- Weather related risks: Agriculture is especially likely to be hit and mining as well as infrastructure may also be harmed. On the other hand, reconstruction efforts may partly counteract the negative effect of the floods. In addition, the increased rainfall will ensure full reservoirs, benefitting hydro-power generation (which suffered during droughts in 2012).

These external and domestic risks, if they materialize, will affect negatively the prospects for growth in the SEE6 countries and slow the nascent economic (Figure 30).[19] In an extreme case of major deterioration of economic conditions driven by the materialization of above risks, SEE6 output growth in 2014 would less than halve (to 0.6 percent) of the baseline projection (of 1.9 percent). In 2015, growth would drop by a third (to 1.7 percent) from the baseline (2.6 percent).

Figure 30: SEE6 Real GDP Growth Rate under Baseline and Low Case Scenarios

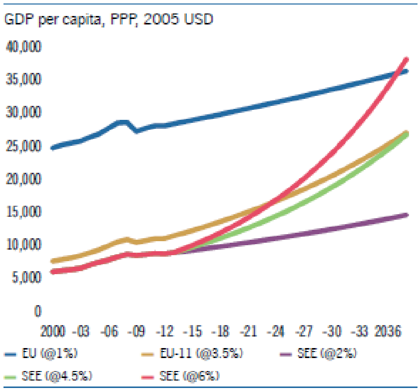


Source: World Bank staff.

[19] IMF (International Monetary Fund). 2012b. *International Financial Statistics*. Washington.

A recent analysis focuses on EU member countries and shows that expanding the growth potential through structural reforms in a stable macroeconomic environment drives strong income convergence.Translated to the SEE6, it means that removing structural rigidities in the macroeconomic policy mix, increasing global integration, improving the economy's productive potential and competitiveness, enhancing skills and labor productivity, and strengthening institutions would ultimately contribute positively to income growth and convergence.

Figure 28: Income Convergence



Source: World Bank staff.

Boosting incomes in the medium to longterm with the aim of converging with EU standards will mean not only maintaining the pace of reforms—but also converting reforms benefits into robust and equitable economic growth. Both of these are proving challenging. The reform pace appears to have slowed during the financial crises. Countries will need to take advantage of the economic rebound to relaunch the reform and convergence processes. There is evidence suggesting that improvements in the business climate should be broad rather than targeted toward specific sectors, as growth and employment creating firms tend to be young and dynamic, but not concentrated in any particular sector. Improving trade links in terms of logistics, institutions and regulations will be important to take advantage of the EU market. In addition, governments need to provide reliable and streamlined processes that guarantee EU safety standards are met for exporting firms, particularly for agricultural exporters. Improvements in governance standards—including the rule of law—will be closely linked to the EU integration process. But reforms required by the EU will also help to boost economic growth in SEE countries.

Such reforms are essential to boost labor demand, reduce unemployment, address the challenges driven by demographic changes and improve prosperity for all in SEE6. Increasing employment is essential to reduce poverty and to bring about shared prosperity in SEE6. Since the major source of income for most households is through selling labor, increasing employment opportunities and ensuring that workers have the skills necessary to take advantage of these opportunities are essential to increase the income generation capacity of the entire population.

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