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| From: | General Secretariat of the Council |
| To: | Delegations |
| Subject: | EU Candidate Countries' Pre-Accession Economic Programmes 2014: Review and Assessment of Monetary and Exchange Rate Policies |

In view of the ministerial dialogue lunch between the economic and finance ministers of the EU and the Candidate Countries of 6 May 2014, delegations will find attached

"EU Candidate Countries' Pre-Accession Economic Programmes 2014: Review and Assessment of Monetary and Exchange Rate Policies"

endorsed by the members of the EFC and representatives of the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey on 24 April 2014 as a background document.

EUROPEAN CENTRAL BANK
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**ECB-RESTRICTED**
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# EU Candidate Countries' Pre-Accession Economic Programmes 2014:

# Review and Assessment of Monetary and Exchange Rate Policies

***Prepared by ECB staff for the Economic Dialogue with EU Candidate Countries***
***Spring 2014***

## Table of contents

# Introduction

This report reviews and assesses monetary and exchange rate policies in four of the five EU candidate countries, namely the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey. It is based on the 2014 Pre-Accession Economic Programmes (PEPs) prepared by these four countries, which outline the main economic policy developments and objectives over the medium-term. As of the cut-off date for this report[1], Iceland had not submitted a PEP report.

The report is the ECB's contribution to the Economic Dialogue with the candidate 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. Monetary and exchange rate policies are crucial in pursuing the goal of price stability, anchoring inflation expectations and thereby providing a framework that fosters macroeconomic and financial stability.

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, recent developments and the outlook for policies. A data appendix providing an overview of selected indicators with particular relevance to the conduct of monetary and exchange rate policy is provided at the end of the document.

[1] The data in the report have 4 March 2013 as cut-off date.

# 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 former Yugoslav Republic 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 participates on a regular basis in the foreign exchange market in order to maintain a stable exchange rate. The fixed exchange rate 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. Open market operations include both domestic operations (consisting mainly of monthly auctions of central bank bills with 28-day maturity in order to absorb the banking system's structural liquidity surplus with respect to the central bank) as well as foreign exchange interventions. Other available 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*

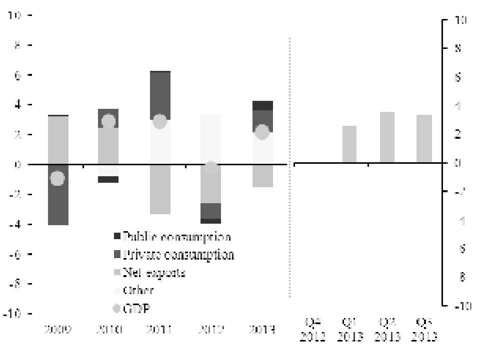
**The pace of economic activity has picked up in 2013.** Following a mild recession in 2012 (-0.4%), economic activity bounced back in 2013 driven by a dynamic construction sector and a moderate recovery of industrial activity in the course of the year. Real GDP for 2013 as a whole is estimated by the authorities to have expanded by 3.3%, with positive contributions from private consumption and investment and a still negative contribution of net exports (see chart 1).[2] Persistently high

[2] Data on real GDP growth from national sources and the IMF (chart 1) may differ due to the fact that the last update of the WEO was in October 2013 and new data (or revisions to previous statistics) may have become available thereafter. While the Pre-Accession Economic Programme submitted by the former Yugoslav Republic of Macedonia late 2013 suggests an increase in real GDP of 3.3% in 2013, the WEO October update puts this figure at 2.2%.

unemployment was only down by 2pp to 29% in 2013 and is mostly structural in nature (notwithstanding possible measurement errors). Coupled with the fact that most FDI projects tend to be only modestly linked with domestic supply chains and are thus not expected to make significant dents on overall unemployment rates, this prompted authorities to take a number of steps to foster employment, in particular among the young.[3]

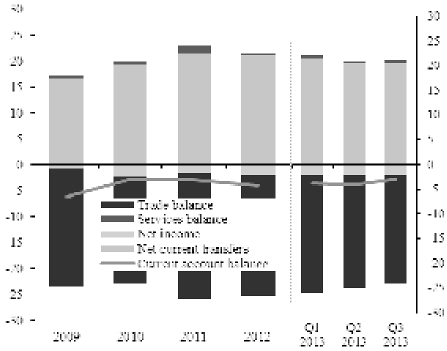
**Real growth is expected to remain strong in 2014, including in comparison to regional peers, as exports and public investment gather pace.** Authorities expect a real output expansion of 3.2% in 2014, further accelerating to 3.8% and 4.5%, in 2015 and 2016 respectively.[4] These estimates are broadly in line with those of the IMF, while they are above those of the European Commission (EC) (which foresees 2.5% real growth for 2014, and 2.6% for 2015). Downside risks to this benign outlook primarily emanate from the possibility that renewed external headwinds weigh on domestic economic activity. On the domestic side, the extent to which strong activity in the technological and industrial development zones (TIDZ) can spill over to the rest of the economy also remains in doubt.

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




*Sources: IMF/WEO (figures for 2013 are projections) and ECB calculations.*

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




Note: Quarterly figures are a moving sum of the most recent four quarters.
*Sources: Haver Analytics, National Bank of the Republic of Macedonia and ECB calculations.*

**As was also the case in previous years, the 2013 budget deficit target was revised upwards.** The end-year fiscal outcome fully matched this revised target (with the deficit at 3.9% of GDP, slightly higher than the 3.5% initially envisaged in the 2013 PEP, largely due to a one-off payment of arrears

[3] Mainly through higher spending on labour market activation policies, in particular for the age group 15-24, in which over 50% are unemployed.
[4] Thereby growth in 2015 and 2016 is expected to be higher than estimated potential growth (3.5%).

in the first semester of 2013)[5]. Looking forward, authorities' commitment to maintaining a low tax environment suggests that fiscal consolidation will depend on GDP growth and discipline on the expenditure side, with capital expenditure likely being the main adjustment variable in case revenues disappoint. However, in spite of the positive economic outlook, the budget deficit is not expected to come down to below 3% before 2016 (2.6% of GDP) in the base line scenario, in part due to the authorities' intention to keep capital investment high (railways, gasification, hospitals). They expect a fiscal deficit of 3.5% and 3.2% of GDP in 2014 and 2015 respectively.

**Public debt remains moderate but has been rising fast, while the composition of debt poses lingering risks**. The ratio of public debt to GDP remains relatively moderate at 40% in 2013Q3. Thus, it is more the recent steep upward trend of public debt rather than its overall level which gives cause for concern, since the country's initial position in the run-up to the crisis was favourable (with debt to GDP amounting to 21% in 2008). The growing indebtedness of state-owned enterprises (where external debt rose by 43% in 2013) should also be monitored closely in a medium-term context. The composition of public debt poses lingering vulnerabilities, since short-term liabilities represent around 25% of the total public debt stock and thus renders the sovereign exposed to rollover risk. Authorities are trying to reduce the vulnerabilities inherent in the public debt structure by making increased use of denar-denominated securities at lengthened maturities. In this context, the Ministry of Finance successfully sold two debut issues of ten-year bonds worth a combined MKD 176.5 million (EUR 2.9 million) in January 2014, of which MKD 65 million (EUR1.07 million) did not carry foreign exchange clause. Prior to this, the longest maturity of government securities placed on the domestic market was five years.

**Overall, gross borrowing needs by the public sector (sum of the budget deficit and debt redemptions) are likely to remain sizeable in the period ahead**[6]. The introduction of sustained fiscal adjustments would thus create sufficient space for spending on items which authorities deem as a priority (such as infrastructure), while putting public debt-to-GDP on a downward trajectory. This would also lead to a more balanced policy mix by reducing the burden on monetary policy.

**External developments have been somewhat less challenging in 2013, but future vulnerabilities are expected to remain sizeable**. While remaining at a high level, the trade deficit moderately edged downwards to 20.2% of GDP, with 85% of this deficit being covered by net current transfers (remittances). This was a positive development, but it also points to the economy's dependency on this form of finance and the potential threat to external balances should these inflows disappoint in the future. As a result of these developments, the current account deficit marginally declined to 2.9% of GDP. Government borrowing from abroad and FDI were the main inflows on the capital and financial

[5] Accumulation of large arrears until the first quarter of 2013 suggests lingering weaknesses in fiscal governance, particularly regarding the public procurement process. However, the government is introducing a system of commitment control in public procurement processes to prevent renewed excessive accumulation in arrears.
[6] According to the Fitch rating agency, gross borrowing needs of the public sector will amount to 13% of GDP in 2014, rising to 14.4% in 2015. See http://www.finance.gov.mk/files/u4/full_rating_report_oct_2013.pdf.

account in 2013. Looking forward, the envisaged strength of public investment along with the high import content of FDI is expected to contribute to widening external imbalances. Authorities are of the view that this will be redressed in time through heightened exports and increased growth potential, including from returns to public infrastructure projects. Against this background, the NBRM took advantage of seasonal factors in end-2013 to make net purchases and thus contributing to maintaining adequate reserve buffers. The modest reserves decline in 2013 (as also evidenced in chart 4) was mainly due to valuation factors. Looking forward, adequate reserve levels will remain key to maintain the credibility of the peg.

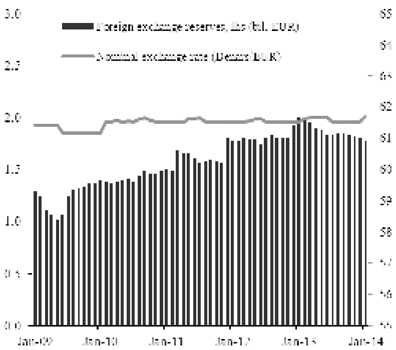
*Inflation, exchange rates, monetary policy and financial stability*

**Inflation picked up temporarily in mid-2013 due to higher food prices,** but subsequently edged down as this effect phased out and energy prices declined. The temporary spike in inflation (4.2% y-o-y in June) is explained by the fact that foodstuffs account for 38% of the CPI basket. Inflation at end-2013 stood at 1.4% y-o-y and has remained at a low level into 2014, at 0.9% y-o-y in January 2014 (see chart 3). Despite the fall in headline inflation in the second half of 2013, core inflation remained at elevated levels.[7] Looking forward, the PEP expects an average inflation rate of 2.7% in 2014, with food and energy prices again being the main drivers.

**Chart 3. Consumer price inflation**
(annual percentage changes)


*Sources: State Statistical Office of the former Yugoslav Republic of Macedonia, National Central Bank and ECB staff calculations.*

**Chart 4. Foreign exchange reserves**




*Sources: Haver Analytics and National Bank of the Republic of Macedonia.*

**The central bank has continued to tightly manage the exchange rate.** The NBRM has intervened on the purchase and sale side for both exchange rate and precautionary (fx reserves) motives. Overall,

[7] This was due to a mixture of second-round effects and assumedly one-off effects owed to changes in the CPI basket. In January 2014 core inflation had fallen to below 2%.

the central bank has been a net purchaser of fx reserves to the tune of EUR 11 million in 2013 as a whole, with the nominal exchange rate of the denar to the euro remaining broadly stable. The reserve coverage ratio amounted to about 4 months of imports of goods and services in end-2013 which may be deemed as sufficient to cope with any unforeseen shocks to the monetary and exchange rate policy framework (see chart 4).

**With inflationary pressures broadly in check, the NBRM has tried to support lending activity through standard and non-standard measures**. The central bank reduced its key policy rate (the rate on the monthly auction of central bank bills) by a cumulative 50bps in two steps in early and mid-2013, and has kept interest rates on hold since at 3.25%. In parallel, authorities have increasingly resorted to modifications of reserve requirements rules to support the pace of credit extension by banks. This has included (i) deduction of newly approved loans to net exporters and domestic producers of electricity from banks' reserve requirement base; (ii) a 0% reserve requirement for liabilities based on debt securities issued in domestic currency with original maturity of at least two years; (iii) a 0% reserve requirement for liabilities to non-residents and financial institutions at different contractual maturities (one or two years); and (iv) the lowering of reserve requirements in domestic currency from 10% to 8%, while that for liabilities in foreign currency was increased from 13% to 15%. The latter measures were also meant to provide further support to the growth of denar savings and stimulate the inflow of foreign capital into the domestic economy, as an additional source of funding of the banking system. The central bank also made a number of changes concerning provisioning rules to foster the resolution of non-performing loans, providing banks with more leeway in taking into account collateral value of claims that are more than 90 days past-due, and introducing a mandatory annual reduction of foreclosed assets in order to accelerate sales of these on the market.

**Chart 5. Interest rates**
(percentages per annum; monthly averages)

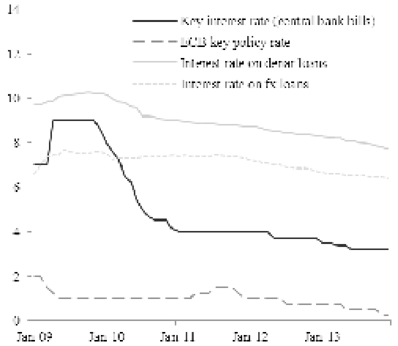
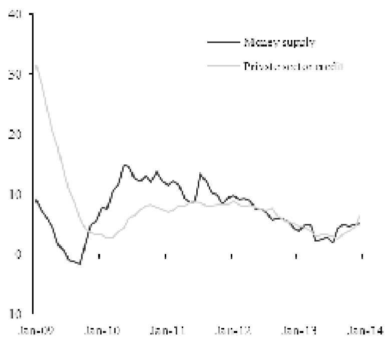



**Chart 6. Money and credit growth**
(annual percentage changes)




Notes: Key interest rate for the former Yugoslav Republic of Macedonia refers to the 28-day weighted average interest rate on the Central Bank Bills auctions. The interest rate on denar-denominated loans is an average of annual interest rates on short-and long-term loans in denar, both for loans with and without a currency clause. Money supply covers M4.
*Sources: Haver Analytics, IFS, National Bank of the Republic of Macedonia and ECB staff calculations.*

**The impact of these measures on the overall rate of credit growth appears to have been limited thus far**, though the pace of credit extension did pick up in 2013H2 and thereby partly reversed the declining trend in the earlier part of the year (see chart 6). However, effective interest rates on loans are coming down only gradually (see chart 5), pointing to impairments in the monetary policy transmission mechanism.

**The NBRM continued its policy of denarisation (or de-euroisation), with some success.** From a flow perspective, the bulk of the positive contribution to overall credit growth in 2013 as a whole was in the form of denar-denominated loans, since the stock of fx-denominated loans has remained broadly unchanged in annual terms. The central bank's policy of differentiated reserve requirements (see above) should also be seen in that context. In spite of this, the share of fx and fx-indexed loans to total loans remained significant at 54% in September 2013.

**The banking sector overall is sound, but challenges remain in both the short and medium-term.** The banking system appears to exhibit comfortable capital and liquidity buffers. Regulatory (Tier-1) capital to risk-weighted assets stood at 14.7% in 2013Q2, and thereby well-above the 8% regulatory minimum set by domestic supervisory authorities, while liquid assets amounted to 32% of total assets and 55% of short-term liabilities in 2013Q2[8]. However, in spite of these positive traits, a number of challenges to financial stability remain. In the short-term, rising credit risk is a concern, as shown by the ratio of non-performing loans which, although moderate in comparison to some peer economies, has been on the rise to double-digit levels (11.8% in 2013Q2).

In the medium-term, the system's indirect vulnerability resulting from asset and liability euroisation (through unhedged borrowers in the event of adverse exchange rate developments) remains large, constituting a tail risk to the outlook. 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[9], the potential impact of the restructuring of (Greek and Slovene) parent entities of locally important subsidiaries following state-aid cases pursued by the EC remains uncertain. At the same time, local subsidiaries of troubled parents remain profitable, suggesting that financial intermediation in a medium-term context should remain unhindered notwithstanding potential short-term disruptions.

## 3. Assessment

**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.** This policy framework enjoys by now a high level of credibility with the denar having displayed continuous stability against the euro in the recent years. Inflation expectations appear to remain anchored, as also evidenced by the NBRM's inflation expectations survey of October 2013.

[8] For more information, see the accompanying ECB document entitled "*Report on financial stability challenges in EU candidate and potential candidate countries*".
[9] The loan-to-deposit ratio was 90% in 2013Q2.

**However, the conduct of monetary and exchange rate policy will continue to face a number of challenges in the period ahead.**

**First, the restoration of the bank lending channel will remain challenging**, as already noted in last year's PEP assessment. The central bank's numerous attempts to remove potential supply-side constraints to the bank lending channel through standard and non-standard measures have thus far yielded moderate results insofar as the downtrend in the pace of credit extension in 2013H1 appears to have been partly reverted. However, it is too early to ascertain the durability of this trend, and rates of credit growth still remain below the levels posted in preceding years (2011 and 2012). Moreover, the burden on banks' balance sheets from non-performing loans remains high, and (as a partial reflection of this) effective rates on loans are coming down only gradually. A lacklustre pace of credit growth does not only reflect an impairment of the monetary policy transmission mechanism but also constitutes a downside risk to the projected recovery in economic activity.

**Second, rising public debt to finance persistent budget deficits risk putting an undue burden on monetary policy making,** as also highlighted in last year's PEP assessment. While the stock of public debt remains low relative to peers, its steep rise in recent years has been notable, including as a result of growing indebtedness of non-financial state-owned enterprises. The government is also exposed to rollover risk given that around a quarter of the public debt stock is short-term in nature. Coupled with efforts to extend domestic debt maturities, the full implementation of the authorities' medium-term fiscal consolidation strategy would be a welcome step to anchor public finances. As deficits are not foreseen to decline below 3% of GDP until 2016, a more ambitious strategy would not only free-up future space for the authorities' spending priorities but also facilitate the environment for the conduct of monetary policy.

**Third, external vulnerabilities remain sizeable and are relevant for monetary and exchange rate policy**. The economy remains dependent on net current transfers to rein in high structural trade deficits. Moreover, external imbalances are set to widen in the near-term as a result of public infrastructure and large (expected) FDI projects, while their favourable impact on external accounts, exports structure and real growth will only be felt in the medium-term. Developments on external balances 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. The tail risks for the banking system (and hence, the potential demands on the central bank as a lender of last resort) in the event of currency depreciation should also not be overlooked.

**Finally, the implications of the authorities' choice of the monetary and exchange rate policy framework for other policy domains in a convergence context should be borne in mind.** In 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.

# Montenegro

## 1. Monetary and exchange rate policy framework

**Montenegro has been using the euro unilaterally since 2002.** Prior to this, the Deutsche Mark had become the sole legal tender in November 2000, at a time when the euro had already been introduced as book money.

**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. Specifically on Montenegro, the ECOFIN Council adopted on 15 October 2007 a declaration recalling that "unilateral euroisation is not compatible with the Treaty, which foresees the eventual adoption of the euro as the endpoint of a structured convergence process within a multilateral framework. An EU Member State cannot adopt the euro and join the euro area without fulfilling all the criteria defined in the Treaty. These comprise the achievement of a high degree of sustainable convergence."[10] In the 2014 PEP, the Montenegrin authorities acknowledge the fact that a specific solution as regards the country's monetary regime will have to be found during the accession negotiations with the EU.

**In the context of unilateral euroisation, the scope for monetary policy in Montenegro is very limited.** Accordingly, the main objective of the Central Bank of Montenegro (CBM) is to "foster and maintain financial system stability, including a sound banking system and safe and efficient payment systems", as stated in the central bank law. The law also foresees that the central bank shall "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 CBM also manages the country's international reserves and advises the government on economic policies. Furthermore, the CBM has some kind of lender of last resort function for which it could use its capital, the minimum reserve requirements held at the CBM by the bank in question and the CBM's capacity to borrow on the market.

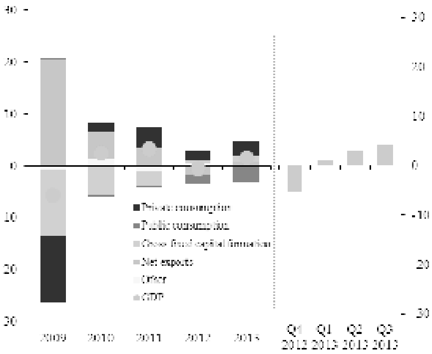
[10] The conclusions add that "the implications of the Treaty framework for Montenegro's monetary regime will be detailed in due course, at the latest by the time of possible future negotiations for accession to the EU".

## 2. Economic and financial developments

*Economic growth, the external sector and fiscal developments*

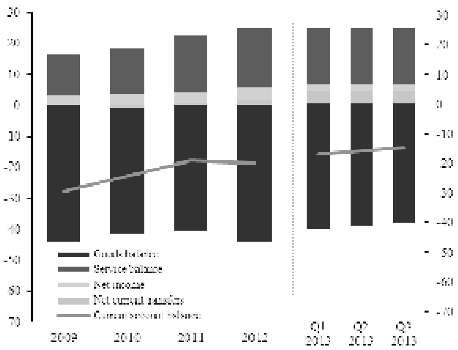
**Economic activity in 2013 bounced back from a significant slump in the preceding year.** Real GDP declined by 2.5% in 2012,[11] much below the authorities' projection of +0.5% in last year's PEP.[12] Economic activity resumed in 2013 with real growth in the year to 2013Q3 amounting to 3.1%, driven mainly by a lower drag from net exports as well as rising industrial production and positive trends in construction, retail trade and tourism. For 2013 as a whole, authorities estimate a real GDP growth rate of 2.6%. If confirmed, this outcome would be very close to the authorities' projections in the baseline scenario of the 2013 PEP where real growth was forecast at 2.5%. After net exports had contributed negatively to growth in 2012, this trend was reversed in 2013 on account of an improved trade balance in goods and services (Chart 1). Negative contributors were gross investment and household consumption (due to suppressed wage and credit dynamics).

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




*Sources: IMF/WEO (figures for 2013 are projections), Haver Analytics and ECB staff calculations.*

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




Note: Quarterly figures are a moving sum of the most recent four quarters.
*Sources: Haver Analytics, Central Bank of Montenegro and ECB staff calculations.*

**Looking ahead, a robust recovery is foreseen over the programme horizon.** For 2014, an annual real GDP growth of 3.6% is expected according to the baseline scenario of the 2014 PEP.[13] Growth prospects will depend to a large extent on projected investment programmes that are envisaged to be

[11] Data on real GDP growth from national sources and the IMF (chart 1) may differ due to the fact that the last update of the WEO was in October 2013 and new data (or revisions to previous statistics) may have become available thereafter. While the Pre-Accession Economic Programme submitted by Montenegro late 2013 suggests a decrease in real GDP of -2.5% in 2012, the WEO October update puts this figure at -0.5%.
[12] The projections of international institutions were also too optimistic at the time, all expecting low but positive growth (European Commission 0.2%, IMF 0.2%, EBRD 0.3%).
[13] This compares to 2.2% (IMF projection), 2.7% (European Commission) and 2.0% (EBRD).

mostly financed by loans and investments from abroad.[14] The pessimistic scenario assumes delays in these projects and foresees a more moderate real expansion of 1.6%.

**External imbalances are slowly decreasing.** The current account deficit, while still on a high level, shrank by 29% year-on-year in 2013 Q1-Q3[15] and is estimated to reach 15.4% of GDP for the whole year after 18.7% in 2012 (Chart 2). A further downward adjustment is expected for the coming years, bringing the level down to 12.6% in 2016. Net FDI decreased by 14.8% year-on-year in the first three quarters of 2013, but their level in relation to GDP remains high compared to regional peers, expected to reach 12.7% in 2013 (down though from 14.7% in 2012). Net errors and omissions remain high in the balance of payments, reaching an estimated 35% of the current account deficit in 2013. This points to a high undeclared inflow of remittances financing the current account deficit.

**External competitiveness remains a matter of concern.** The 2014 PEP contains an analysis of several competitiveness indicators. The depicted rise of the real effective exchange rate between 2009 and 2012 by around 4% suggests a deterioration of Montenegro's competitive position should this pattern remain unabated in the future. Montenegro's world market shares of exports halved during the same period. However, there are also positive signs as real wages have slightly edged down since 2010 and unit labour costs fell in 2013 as compared to 2012, while average gross nominal income remained flat in 2013 as compared to the preceding year, extrapolating a trend already experienced in 2012 and 2011. Other indicators, such as Montenegro's jump in the World Bank's 2014 Doing Business ranking from 50th to 44th place (out of 189 countries) are also encouraging. Overall, the country'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.

**Despite improvements on fiscal performance backed by several consolidation measures, government deficit and debt levels remained high as contingent liabilities to the public balance sheet have materialised.** In line with recommendations of last year's PEP assessment, the authorities introduced a number of consolidation measures in 2013. These include a hike in VAT and personal income tax rates on the revenue side and a freezing of pensions as well as a reduction of costs in the public sector on the expenditure side. These measures are partly continued in 2014. Additional revenues could also be collected as a result of efforts to reduce the grey economy and increase tax compliance in particular of small and medium-sized enterprises. However, overall fiscal performance in 2013 was blurred by the call of government guarantees of around 3½% of GDP for the insolvent

[14] One of these projects is an approximately 110km long highway from Bar at the country's southern coast to Boljare in the north at the border to Serbia from which it will continue in Serbian territory to Belgrade. If implemented, it will be the largest infrastructure project in Montenegro's history. In early November 2013, the government selected two Chinese companies as best bidders for the construction of a first part of the highway with a length of around 40km. Their offer lay at around EUR 800 million (almost a quarter of Montenegro's annual GDP).

[15] This trend was influenced by shrinking electricity imports linked to the reduced activity of the aluminium plant KAP.

aluminium smelter KAP[16], which pushed up the government deficit to 4% of GDP according to the authorities' estimates. Without this development, authorities consider that 2013 budget deficit would have amounted to 0.6% of GDP, down from 6.1% in 2012. Fiscal authorities managed to finance the KAP guarantees without a revision of the 2013 budget inter alia due to higher than expected revenues. Looking ahead, the PEP foresees a reduction of the deficit to 1.3% of GDP in 2014 (in the baseline scenario), turning into a surplus of 0.2% and 0.9% in 2016. The development of revenues in early 2014 has been encouraging. The government debt level is set to stabilise and reach 56.9% of GDP by the end of 2014, up from 56.5% in 2013[17]. This compares to levels of below 30% before 2009.

**Risks to the fiscal scenario mainly stem from the high reliance on large investment projects going forward as well as from contingent liabilities to the public balance sheet**. After the calling of government guarantees for KAP, their overall level has fallen from 11% of GDP in 2012 to 8% in 2013[18]. The bulk remains lying on foreign liabilities. The authorities argue that the risk of guarantees being called is now lower without the KAP guarantees. However, guarantees are usually not subject to the same degree of scrutiny through the budget process as regular spending even though they can have potentially significant fiscal consequences, as proven by the KAP case. Therefore, a prudent, forward-looking policy towards guarantees is crucial in order to safeguard the sustainability of public finances.

**In the context of unilateral euroisation, fiscal policy remains the main macroeconomic adjustment tool, thus putting a higher onus on sound policy execution.** As envisaged in last year's PEP, the government adopted the Law on Budget and Fiscal Responsibility in July 2013 but it still needs to be approved by the parliament. The bill sets the principle of reaching a primary surplus and defines upper limits for public debt (60% of GDP) and the budget deficit (3% of GDP), thereby staying behind earlier drafts of the law which had stipulated stricter rules (i.e. a maximum budget deficit of 1% of GDP and a maximum debt level of 30% as of 2024). While the proposed law reflects the EU Maastricht criteria, a more ambitious approach (as also discussed in last year's PEP assessment) would have been warranted given the country's fiscal track record und the chosen monetary regime. The bill also foresees an independent fiscal council that reports to the parliament on the government's economic policy, and the introduction of a medium-term budget framework. Overall, these measures will strengthen public finances, fiscal responsibility and transparency.

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[16] After several attempts to "rescue" KAP had failed, the Ministry of Finance finally prompted the bankruptcy procedure by the Commercial Court in July 2013. Assets are estimated at EUR 52.5 million, while the company's liabilities amount to EUR 359 million. The first attempt to sell the company ended in January 2014 without success, as only four bids were received in the auction and none was accepted by domestic authorities. In a second bidding round in February only one offer was received from a local private metal trade company which had already participated in the first auction and left its bid practically unchanged. If KAP cannot be sold, the law stipulates that the state will have to take over the company. This in turn would imply a serious threat to the sustainability of public finances in Montenegro.

[17] 77.2% of public debt is foreign debt, up from 76% at end-2012, and set to reach 80.6% by end-2014.

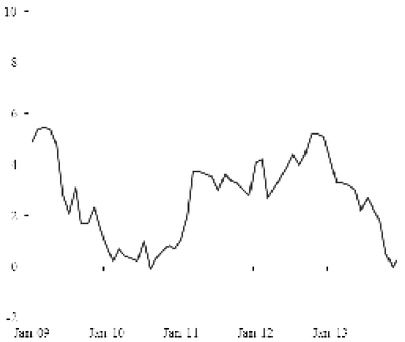
[18] Outstanding guarantees are related inter alia to the railway infrastructure, bauxite mines and Montenegro Airlines.

*Inflation, exchange rates, monetary policy and financial stability*

**Inflation was on a downtrend throughout 2013, in line with international price developments.** The annual inflation rate fell from 4.2% in January to zero in November, before slightly edging up to 0.3% in December (Chart 3). The annual average inflation rate for 2013 thus decreased to 2.2% (half a percentage point below the 2013 PEP estimate), down from 4.1% in 2012. The main drivers of inflation were food and housing prices, while transport prices fell. For 2014, the authorities' baseline scenario foresees an average inflation rate as measured by the CPI index of 2.9%, with electricity prices and an increase in excise duties on tobacco set to be among the core drivers of inflation.

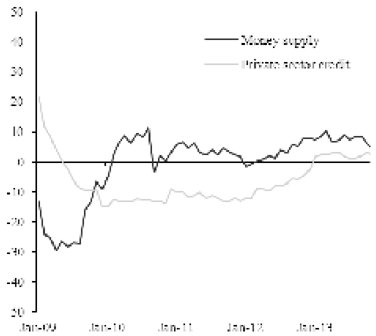
**The true development of credit dynamics is somewhat unclear.** Annual credit growth figures re-entered positive territory for the first time since 2009 in January 2013. However, this development has to be interpreted with care as there is a statistical break in the series[19] (Chart 4). It seems that the economic recovery spurred the demand for loans (reflected in an 8.9% year-on-year increase in credits to households at end-2013, according to available figures). At the same time, the supply side, in particular for corporates, is still impaired by the high level of non-performing loans (NPLs) and risk aversion in the banking sector. The CBM did not extend the temporary upper limits on interest rates which had been introduced in November 2012, given their rather limited impact.[20]

**Chart 3. Consumer price inflation**
(annual percentage changes)



*Sources: Haver Analytics, Monstat and ECB calculations.*

**Chart 4. Money and credit growth**
(annual percentage changes)




Note: Money supply covers money plus quasi-money.
*Sources: Haver Analytics, IFS and ECB calculations.*

**While uncertainty as regards the domestic impact of parent bank restructuring remains a concern for financial stability in the medium-term, credit risk represents the main near-term challenge**, with the ratio of non-performing to total loans reaching 17.7% in October 2013. In reaction to this development, the authorities engaged in a widely observed attempt for the rescheduling and

[19] According to the Central Bank of Montenegro, the growth in loans as of January 2013 primarily resulted from the implementation of International Accounting Standards (IAS 39). Although the series has been revised back to 2009, the pre- and post-2013 figures are not fully comparable.

[20] Average weighted nominal interest rates on newly granted loans dropped by a mere 15 basis points during that period, which is within the normal fluctuation margin for this variable.

resolution of debt ("Podgorica approach" [21]) which entailed inter alia mandatory cooperation and disclosure requirements, a mediation centre to resolve disputes outside courts and deferred tax payments for creditors and debtors during the NPL restructuring process. Furthermore, in November 2013 the CBM adopted guidelines for the banks to present strategies for the reduction of NPLs. A draft law on voluntary financial restructuring and amendments to the CBM's regulation of minimum conditions for credit risk management to accommodate regulatory incentives for banks are scheduled for 2014. Overall, the Montenegrin banking system is showing signs of incipient recovery after a protracted period of correction from the excesses in the run-up to the 2008 financial crisis.

## 3. Assessment

**Montenegro faces the challenge of diversifying the sources of growth and increasing the competitiveness of its economy under the restrictions of unilateral euroisation.** It is a good sign that domestic saving turned positive in 2013[22]. Montenegrin authorities base the country's growth strategy on externally funded infrastructure projects, but have expressed doubts themselves in the 2014 PEP about whether such a model will be conducive to a sustainable economic development in the long run. Under the assumption that once the infrastructure projects are finalised they support domestic production, trade and tourism and thereby strengthen domestic sources of growth, this foreign investment-centred strategy would be superior to the pre-crisis consumption-based model which had proved to be clearly unsustainable. At the same time, these infrastructure projects are likely to be import-intensive and their financing remains uncertain at the current juncture. As a result, their short run impact could be associated to increasing external and domestic (fiscal) vulnerabilities while their expected positive medium to long run effects remain subject to several uncertainties.

**Looking ahead, the continued recovery expected for 2014 and beyond is subject to a number of internal and external macro-financial risks.** First, the significant rise of foreign direct investment expected for the upcoming period may not materialise to the extent expected. Reasons to this end can be manifold, including a reduced risk appetite of international investors, repercussions from the recent capital outflows from emerging markets, a worsening investment climate, and increased reluctance of banks to finance the projects. Second, while recent consolidation efforts are commendable, potential discretional slippages and contingent liabilities endanger fiscal consolidation efforts. In addition, the maturity structure of debt is unfavourable with two large Eurobond issuances becoming due in 2015 and 2016. Third, facing the high level of non-performing loans and given also statistical uncertainties as regards credit developments, the extent to which the moderately resumed lending activity signals improved bank lending remains in doubt. Fourth, the low degree of diversification of the Montenegrin economy with a still dominating metal industry makes it vulnerable to international price developments. Fifth, uncertainties surrounding the fate of KAP weigh on public finances and the

[21] For more information, please refer to the accompanying ECB document entitled *"Report on financial stability challenges on EU candidate and potential candidate countries"*.
[22] According to the IMF, gross national saving to GDP reached 0.3% in 2013 after -1.5% in 2012 and -10% in 2008.

economic activity. Sixth, Montenegro's external vulnerabilities remain sizeable, with risks to the financing of the current account deficit amid rising external indebtedness prevailing.

**Policy degrees of freedom for sustainable convergence are severely hampered by the authorities' monetary and exchange rate policy regime choice.** Unilateral euroisation in a country that has not achieved the necessary degree of sustainable convergence proved inappropriate, especially as it severely constrained the authorities' toolkit to support sound economic policies. At the current juncture, the absence of a reference interest rate and the significant limitations to its lender of last resort function reduce the central bank's ability to influence bank lending and thereby to support economic growth. The new rules-based fiscal framework is a welcome step but the provisions of the fiscal responsibility law still need to be tested and policy-makers have to develop a credible track record. Furthermore, the need for flexible labour and product markets remains apparent.

# 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 of the NBS is integrated supervision of the financial market.

**The inflation target is defined in terms of annual percentage changes in headline inflation as measured by the consumer price index.** The NBS has implemented the inflation targeting regime as of January 2009. The targets are defined as point targets for each month of the year within a tolerance band. The monetary policy objective for 2013-2016, set in cooperation with the government, is 4.0% within a symmetric 1.5pp tolerance band. It remains thus above the quantitative definition of price stability of advanced economies, allowing the price convergence with advanced EU economies. 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. Consistent with the IT regime, the NBS pursues a managed floating exchange rate regime, intervening in the FX market in order to smooth excessive volatility of the dinar exchange rate, to ensure financial stability and to maintain an adequate level of FX reserves.

**The main monetary policy instrument is the key policy rate.** This is the rate applied by the NBS in its main open market operations, notably 1-week reverse repo transactions. As of July 2012, they 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 actively resorts to changes in reserve requirements as well as FX operations, including FX swap transactions, in order to influence the monetary policy transmission mechanism. In addition, the NBS can extend short-term liquidity loans to banks against collateral.

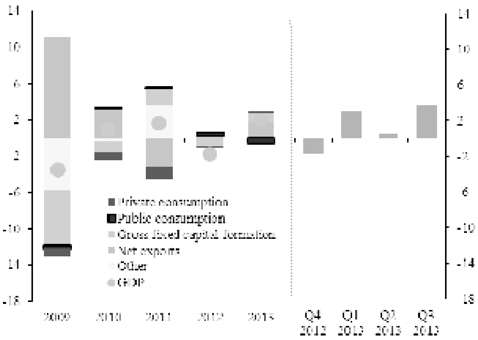
## 2. Economic and financial developments

*Economic growth, external sector and fiscal developments*

**After two recessions in the last four years, the economy embarked on a slow recovery path in 2013.** Following a 1.7% drop in 2012, the country's real GDP grew by 2.4% y-o-y in real terms in

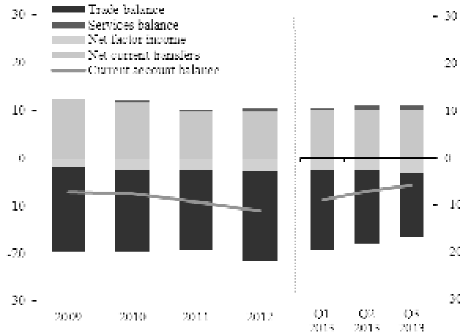
2013(see chart 1).[23] The recovery accelerated strongly in 2013H2, driven mostly by improved net exports as well as by a rebound of agriculture production. According to the medium-term baseline scenario, a gradual economic recovery with real output expanding by 1.6% per annum on average is expected in 2014-2016, broadly in line with the authorities' estimates of potential economic growth. Planned fiscal consolidation and continued negative trend in personal consumption will have a bearing in 2014, with the economy growing by meagre 1%, before it rebounds to 1.8% and 2% of GDP in the following two years, respectively.[24] Downside risks to the outlook stem mostly from a slower recovery than currently anticipated in peer economies and key trading partners in the EU as well as from potential delays in the implementation of economic reforms in Serbia itself. In case these risks were to materialise, the PEP projects a fragile 0.7% real growth per annum on average during 2014-2016, with a real output contraction of 0.5% of GDP in 2014.

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




*Sources: Haver Analytics, National Statistical Office, IMF (figures for 2013 are projections) and ECB staff calculations.*

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




Note: Quarterly figures are moving sum of the most recent four quarters.
*Sources: National Bank of Serbia, Statistical Office of the Republic of Serbia, Haver Analytics and ECB calculations.*

**Net exports are expected to constitute the biggest driver of growth going forward.** This is primarily a result of a recent expansion in the automobile and oil industries. Despite some improvements to the structure of exports, the economic recovery has remained narrow-based and has not translated into improvements to poor labour market conditions.[25] Together with the effects of fiscal consolidation, this has contributed to a further drop in domestic demand in 2013. Both private and

[23] Serbia posted an increase of 3.0%, 0.6%, 3.7% and 2.6% of real GDP compared to respective quarters in 2012. The 2013 output is higher than PEP estimates (2% y-o-y) as well as estimates from other institutions. Data on real GDP growth from national sources and the IMF (chart 1) may differ due to the fact that the last update of the WEO was in October 2013 and new data (or revisions to previous statistics) may have become available thereafter. While the Pre-Accession Economic Programme submitted by Serbia late 2013 suggests an increase in real GDP of 2.4% in 2013, the WEO October update puts this figure at 2.0%.

[24] Contrary to previous years when the authorities were overly optimistic, the PEP projections for both 2014 & 2015 are skewed downwards. Moreover, the PEP presents an alternative scenario for the first time.

[25] Unemployment remained elevated at 25% at end-2013, with youth unemployment being of a particular concern.

government consumption are projected to impact negatively the country's performance in the coming 3-year period, whereas the PEP expects investment activity to pick up strongly.

**External imbalances have narrowed down significantly.** Against a rapid exports expansion, both the trade and current account deficits were cut by approximately one third to 12% and 6% of GDP respectively in 2013 (from 18% and 10.5% the previous year, see chart 2). Total external debt, which was driven primarily by increased public indebtedness in the recent years, is expected to stabilise at 85% of the GDP in 2016, also due to expected savings in view of fiscal adjustment. The current account deficit was mostly covered by dynamic portfolio investments in 2013, whereas a surge of FDI is expected in the period ahead. The sustainability of the current account balance over a longer time perspective would thus appear to depend on the implementation of structural reforms and improved competitiveness of the export sector.

**A sharp reduction of the fiscal deficit and curbing public indebtedness are crucial in order to achieve a balanced policy mix.** In spite of a series of ad-hoc consolidation measures in April and October 2013, primarily due to revenues falling short of target, and a full budget revision in June,[26] both the general government deficit and debt are estimated to have edged up to 6.5% (including all additional costs[27]) and 64.2% of GDP respectively in 2013. The authorities' planned deficit for 2014 equals 7.1% of GDP, which is higher than the previous year as well as in comparison to regional peers. Looking further ahead, the PEP envisages a gradual reduction of the public deficit and a stabilisation of the public debt in real terms in 2016 (at 69.7% of GDP with additional costs). However, fiscal balances are not seen to be in surplus and public debt is not anticipated to return to its legal limit of 45% of GDP until 2025.[28] This projected fiscal consolidation path[29] thus appears as relatively unambitious in light of both the continued upward trend in public deficits and indebtedness in recent years and the limited room for fiscal policy manoeuvre amid a changing international environment. More decisive steps on the fiscal realm would also contribute to rebalancing the burden of adjustment away from monetary policy authorities. The possibility of a new IMF programme, which authorities are understood to be currently discussing, might help as an anchor to achieve these challenging goals.

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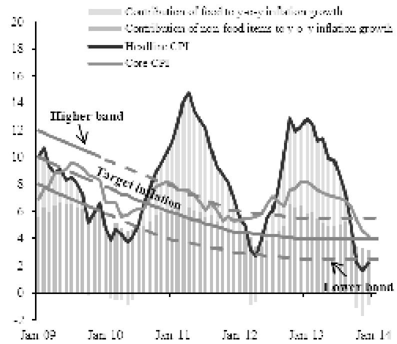
[26] The 2013 general government deficit target was raised from 3.6% (as presented in last-year PEP) to 5.2% of GDP (without additional costs), after reaching 6.4% the year before.
[27] This includes paying of activated guarantees, recapitalization of banks and assumed debt of some state entities.
[28] In comparison to the last year PEP, this represents a postponement by 5 years. Although the 2013 projections might have been biased towards an optimistic scenario, the postponement is also a sign of inability to introduce key reforms.
[29] These include VAT hikes, reduction of subsidies, fixed indexation of wages and pensions until 2016, combating the shadow economy and refinancing of the expensive portion of public debt, pension system reform, reduction of public sector salaries and employment as well as introduction of financial activities tax.

*Inflation, exchange rates, monetary policy and financial stability*

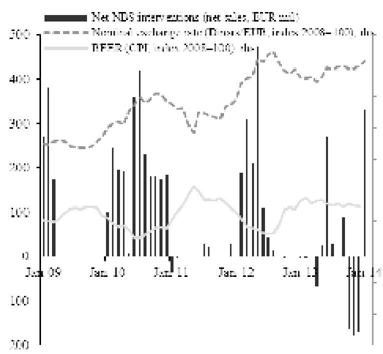
**Inflationary pressures and inflation expectations have subsided sharply.** Following a food price shock in 2012, annual headline inflation rose to 12.8% in January 2013, thereby significantly overshooting the target (of 4%±1.5pp). Inflationary pressures subsequently weakened during the year, particularly as of 2013H2, mostly on the back of falling food prices, low aggregate demand and a relatively stable exchange rate, respectively. As a result, after a 14-month period off target, headline inflation returned to within the tolerance band in September (at 4.9%), fell to its historical low in November (1.6%, see chart 3), and closed the year at 2.2%, respectively. It has since remained around the lower end of the tolerance band, reaching 3.1% in January 2014. The easing of inflationary pressures was associated with a decline in inflation expectations (one year ahead) which entered the target tolerance band as of October 2013. Looking ahead, the central bank anticipates that inflation will rise moderately in the coming months, on the back of increase in administered prices and ad-hoc hikes in taxes, and move within the target tolerance band, absent any major shocks. The main risks to the projections are stemming from the international environment and the success of the anticipated fiscal consolidation in 2014H2, respectively.

**Chart 3. CPI inflation**
(annual percentage changes)




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

**Chart 4. Exchange rate variations**




**Developments in 2013 confirmed the high volatility of headline CPI inflation in Serbia, driven in particular by pronounced food price shocks.** This was the second significant and sustained deviation from the target in the last four years that was largely associated to a bad domestic agricultural season. Looking ahead, the shocks to headline inflation could be dampened in the medium term by recent statistical changes to the CPI basket reducing the weight of food and administered prices[30], as well as by an expected liberalisation of trade in agricultural products,[31] both underpinned by Serbia's EU accession context. Although the weight of food in the CPI basket even prior to the recent changes was not out of line with that of regional peers, a number of structural shortcomings, largely outside the remit of the central bank, are seen to exacerbate the volatility of food prices in Serbia.[32]

**The central bank intervened in FX markets on both the selling and buying side.** The dinar fell by 1% in nominal terms against the euro in 2013 (see chart 4), with relative fluctuations largely influenced by investors' reassessment of underlying risks in Serbia against anticipated changes to the Fed's quantitative easing policy. In this context, a negative assessment of the state of public finances in the IMF's Article IV report (in May) and the announcement of new fiscal consolidation measures (in October) were associated with significant changes in external investor appetite for government securities.

**Chart 5. Interest rates**
(in percent)

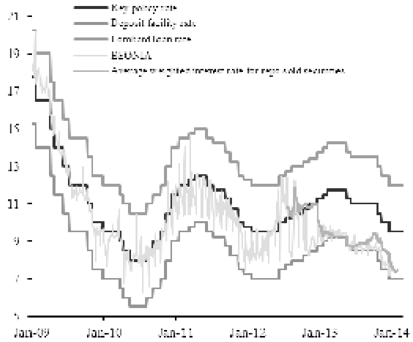
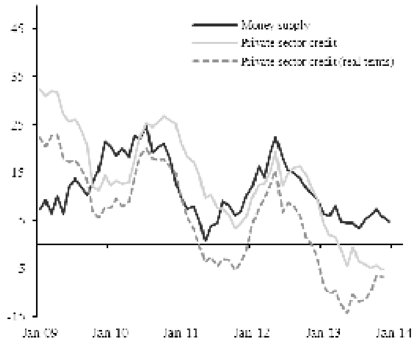



**Chart 6. Money and credit growth**
(annual percentage change)




Note: Money supply covers M3.
*Sources: Haver Analytics, IFS, NBS and ECB staff calculations.*

Downward pressure on the domestic currency and upward movements in government bond yields were again manifest in January 2014 in response to both external and domestic factors. Against this background, the central bank has stepped in frequently in the FX market in order to smoothen daily fluctuations, with interventions in 2013 amounting to net purchases overall (selling EUR 435 million and buying EUR 615 million over the year), while the trend in the first months of 2014 points to the

[30] The change refers to the harmonisation of data source with the EU (using national accounts instead of Household Budget Survey data, following Eurostat recommendations). As a consequence, the weight of food prices in the CPI was reduced as of 2013 (by more than 4pp to 34.52%). Similarly, the weight of administered prices, which still display a low rate of convergence with the EU average, fell by 2pp to 20.41% in 2013 (20.47% in 2014), which is also expected to contribute to the stabilisation of inflation volatility.

[31] A gradual liberalisation of agricultural products exchange with the EU is based on the Interim agreement. As of 2014, the average import customs for agricultural products was lowered by 3pp to 3.9%.

[32] These include high food import protection, absence of adequate systemic agrarian measures, lack of competition in the production/trade chain or large state interventions, e.g. in commodity reserves system. For details, see *World Bank (2012): Serbia – The Road to prosperity: productivity and exports.*

opposite direction (sale interventions amounting to EUR 510 million). The level of international reserves, at EUR 11.2 billion at end-2013, was sufficient to cover around 7 months of goods and services imports.

**The central bank has taken a cautious approach to relaxing its policy stance**. In light of continued inflationary pressures in early-2013, the NBS increased its key policy rate by a cumulative 50 bps, to 11.75% in early 2013. Anticipating a rapid inflation deceleration, the central bank reversed its policy stance as of May, cutting its key policy rate in 5 steps by a cumulative 225bps. The policy rate now stands at 9.5% and has not been changed since November 2013 (see chart 5). Overall, the central bank appears to have taken a cautious stance as regards policy easing, especially in periods when stronger downward pressure on the currency could potentially give way to upside risks on inflation due to high exchange rate pass-through as well as latent risks to financial stability amid high liability euroisation. Although the monetary policy stance appears as rather tight especially in light of underlying credit conditions (see below), the changing external environment and the impact of potential fiscal consolidation measures in 2014H2 continue to point to diverging upside and downside risks to the inflation outlook. Moreover, the central bank continues to pursue a policy of incomplete absorption of excess liquidity by the banking system, which has brought the average interest rate on traded securities below the key policy rate as of late 2012. Although the deviation in this regard became smaller in 2013H2, this trend was not sustained and the remaining gap thus continues to partly blur the monetary policy signal.

**Lending activity has ground to a halt**. The pace of credit extension has been declining since the mid-2012 and entered negative territory in 2013 (chart 6). Lending declined in particular in the corporate sector, where the contraction reached almost 10% in nominal terms on an annual basis by December 2013. The downtrend in credit is seen to reflect both demand and supply factors, including the termination of large subsidised lending programmes,[33] potential crowding out by the public sector, deteriorated creditworthiness of the private sector, and tighter lending standards amid already high lending rates against sizeable NPL burdens in bank balance sheets.

**The banking sector is undergoing consolidation and restructuring, creating an additional burden to already stretched public balance sheets**. The failure of four local (and mostly state-owned) banks in the last 2 years has introduced a degree of consolidation to the banking sector, albeit at a significant cost to the public coffers (estimated at EUR 860 million).[34] Looking ahead, the banking system is likely to undergo further consolidation - not only as the number of banks still operating in the country remains high, but also due to the further restructuring of EU-based parent entities, e.g.

[33] The impact of these loans on acceleration in lending was particularly visible in 2010 (EUR 1.9bln of subsidised loans) and in late 2012 (EUR 1.1bln). Moreover, most of the loan receivables of banks that were de-licensed since October 2012 were excluded from banking sector balance sheets.
[34] Univerzal Banka (January 2014), Razvojna banka Vojvodine (April 2013), Privredna banka Beograd (October 2013) and Nova Agrobanka (May 2012, a bridge bank created following a collapse of Poljoprivredna banka Agrobanka in December 2011)

following state-aid cases pursued by the EC.[35] Notwithstanding ring-fencing measures in place, the likely changes as regards banking structure will represent a communication challenge for authorities given developments in the not-so-distant past.[36]

**Financial stability challenges will remain sizeable in the period ahead.** The banking sector continues to display adequate capital and liquidity buffers and it remains profitable as a whole.[37] In addition, the central bank has prepared a strategy for Basel III standards implementation by end-2015. However, credit risk remains a matter of pressing concern in the near-term, with the share of NPLs in total loans exceeding 21% in 2013Q3. Authorities have implemented several measures since 2012 in order to foster NPL resolution, although thus far with little success. In the medium-term, indirect market risk represents a challenge on account of the stubbornly high level of liability euroisation of the economy, thereby potentially affecting asset quality in bank portfolios through unhedged borrowers.[38] In this regard, the authorities' dinarisation strategy does not appear to have gained much traction.[39]

### 3. Assessment

**The monetary policy stance adopted by the central bank in 2013 was geared at curbing inflation and managing inflation expectations.** The central bank reversed to an accommodative monetary policy stance in light of easing of inflationary pressures amid a rather protracted economic recovery. However, the central bank faced difficult policy trade-offs between external and domestic objectives. In this context, the sizeable funding needs of the public sector in a changing global environment and the potential knock-on effects of any shortfalls on domestic asset prices (notably the exchange rate) in a highly euroised economy emerged as major constraints on policymaking. The central bank's frequent intervention in the FX market and the very gradual relaxation of its monetary policy stance are indicative of such constraints. Concerning the implementation of the monetary policy stance, the central bank has continued its policy of limited mopping up of liquidity, with the gap between the key policy rate and the average reverse repo rates being maintained, thus partly blurring the monetary policy signal.

**Reviving credit growth is essential for economic recovery.** It is difficult to foresee a sustained recovery in economic activity while credit to the private sector remains stagnant or at negative nominal rates of growth. As a result, improving the conditions for credit extension as well as the

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35 The foreign liabilities have so far remained broadly stable. Moreover, the domestic subsidiaries of EU-headquartered banking groups are changing their funding model, re-orienting their funding sources towards local deposits. For details, see the accompanying ECB document entitled *"Report on financial stability challenges in EU candidate and potential candidate countries"*

36 Serbia experienced a bank run in October 2009, when almost 20% of all household deposits were withdrawn.

37 The capital adequacy ratio stood at 19.9% at 2013Q3, well above the statutory limit of 12%, and the liquidity ratio, measured as liquid assets to short-term liabilities, reached 62% in the same period. Also, ROE was approximately 3.8% in 2013Q3, down from 5.3% the previous quarter.

38 More than 70% of all loans and almost 80% of all deposits were denominated or indexed to foreign currency, mostly euro, in end-2013. Moreover, FX-denominated debt remained dominant (with 80% share) for the total public debt.

39 The central bank applies macro-prudential measures. Moreover it uses communication and consumer protection channels as well as is active with respect to the development of local capital markets and hedge instruments.

effectiveness of the transmission mechanism to longer-term interest rates by addressing structural bottlenecks in credit channels should appear as a key policy priority for the authorities going forward. In this context, measures to foster the resolution of the high stock of non-performing loans on banks' balance sheets are of the essence in the short-term. In a medium-term context, these efforts should be complemented with policy steps to improve the competitiveness of the private sector. Moreover, maintaining macroeconomic stability appears critical to the consecution of both the short- and medium-term objectives.

**The central bank should continue to take the opportunity of low inflation to fully cement its anti-inflationary credentials.** Although the IT regime has managed to considerably bring down the volatility of overnight interbank interest rates, headline inflation has been subject to large oscillations. Since 2009, inflation has moved within the target band less than 35% of the time. Successive failures to meet established inflation objectives have damaged the credibility of the framework, hindering both the central bank's ability to durably anchor inflation expectations and the authorities' dinarisation policies. Looking forward, maintaining inflation within the established objectives and reducing the high volatility of inflation will thus continue to represent a major challenge. In this context, the planned extension of inflation expectation surveys to a two-year horizon should be a helpful tool for monetary policy makers.

**Several factors, many of them outside the remit of the central bank, are putting a high burden on monetary policy making in Serbia.** First, the economy has faced two **pronounced food price shocks** in the last years, which contributed to sustained periods in which inflation was off-target. Despite some mitigating factors introduced in 2013, determined action from the authorities to address the structural issues influencing the food price-formation process would be important to reduce both the magnitude and the incidence of food price shocks on headline inflation, as already highlighted by previous PEP assessments. In addition, better communication between the government and the central bank, in particular with respect to **expected changes in administered prices**, would also be key given their large weight in the CPI basket.[40]

Second, **putting public finances on a sustainable footing** would also facilitate the conduct of monetary policy, especially in light of the downside risks posed by a changing international environment. Although the recent periods of downward pressure on the dinar are partly a consequence of renewed global financial market tensions, it is also a sign of the country's long-standing domestic challenges on the fiscal front, as also indicated by the recent sovereign credit rating downgrade. In this regard, and as also recognised in our previous assessment, fiscal consolidation pursued in an expeditious manner as well as further progress in structural reforms to support the incipient economic recovery are of paramount importance. This would not only alleviate the disproportionate burden of

[40] The central bank has called upon the Serbian government to prepare a medium-term plan of administered price revisions in order to stabilise the business environment and contribute to anchoring of inflation expectations (see Letter from central bank Governor to Serbian Prime Minister from January 2013).

adjustment on monetary policy, but also reduce the public sector's dependency on debt-creating sources of finance from abroad and enhance the country's resilience to external shocks.

Third, constraints to the prevailing monetary policy framework would be improved by reversing the **pervasive asset and liability euroisation** in the economy. Serbia continues to face one of the highest degrees of unofficial euroisation in its financial system, in spite of the authorities' dinarisation strategy in recent years. Besides the existing macro-prudential measures (e.g. by applying diverging reserve requirements to fx and dinar deposits), local capital market development (including hedging instruments) should be deepened further. The government could play a pivotal role in this context by strengthening and lengthening the domestic yield curve. However, experience suggests that these efforts could only be seen as complements to, rather than substitutes for, increased macroeconomic and price stability in a comprehensive dinarisation strategy.

# 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 regime 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. The exchange rate regime is an independent float[41] 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 2013-2016 the inflation target has been set at 5.0% surrounded by a ±2% uncertainty 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 adopted a more unorthodox 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 provided at the policy rate – provides the CBRT with more policy flexibility to fine-tune interest rates and to heighten uncertainty about returns from money market investments; (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 unremunerated reserve requirements in foreign currency and gold with a system of reserve options coefficients (ROC) guiding the costs of

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

using the ROM[42]; 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*

**In response to the Turkish authorities' efforts to engineer a soft landing of the economy and achieve a rebalancing away from domestic demand, output expanded by a mere 2.2% in 2012. However, growth rebounded briskly in the first three quarters of 2013, also supported by accommodative monetary and fiscal policies** (see Chart 1). In the first and the second quarter of 2013 GDP rose by an annual rate of 3.0% and 4.5%, driven by robust private consumption on the back of buoyant credit growth (+33.6% y-o-y as at December 2013), a surge in public investment and an accumulation of inventories. In the third quarter of 2013, activity moderated only slightly (+4.4%), notwithstanding tighter domestic and global financing conditions that dampened consumption as well as investment. Following their solid positive contribution to GDP in 2012, net exports subtracted from growth in 2013 as a consequence of the strong increase in import demand and base effects from Turkey's gold trade.[43]

**For 2014, the Turkish authorities appear to be relatively sanguine about economic prospects whereas other analysts mostly provide a more cautious assessment.** While acknowledging considerable downside risks the CBRT and the Treasury still forecast growth at close to 4.0% in 2014, in line with the government's medium-term economic programme of October 2013, despite the recent political tensions, the CBRT's substantial policy rate hike in January and the tangible deterioration in Turkey's external financing environment. By contrast, latest figures from the European Commission project GDP to expand by only 2.5% in 2014, roughly in line with the February 2014 Consensus Forecast of 2.6%.

**Mirroring Turkey's economic cycle, the current account deficit widened to 7.3% of GDP by the third quarter of 2013.[44] In 2012, it had contracted to 6.2% of GDP from double-digit levels in 2011** (see Chart 2). The increase in the current account deficit was primarily driven by a widening

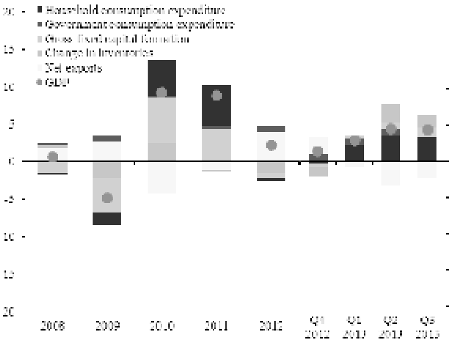
[42] The ROM allows banks to hold a certain share of their required reserves in foreign currency or gold instead of Turkish lira. Exercising this option comes at a cost that is determined by the ROC which indicates the amount of foreign currency or gold to be held for each unit of Turkish lira. The ROM 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.

[43] Sizeable gold exports in 2012 resulted in Turkey recording a surplus in its traditionally negative gold trade balance for that year, necessitating a replenishment of gold stocks in 2013 that lifted the gold trade deficit to an unusually high level.

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

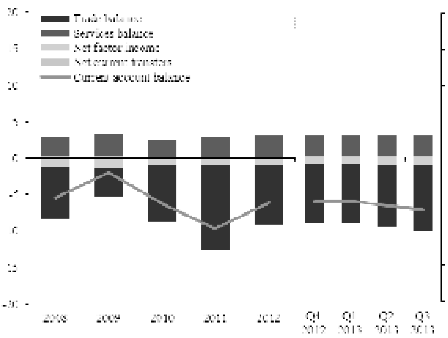
deficit in the trade balance, stemming from rising imports on the back of improving domestic demand and a comparatively sluggish export performance as a result of the subdued economic environment in the EU, Turkey's main export market.

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




*Sources: Turkish Statistical Institute, Haver Analytics and ECB staff calculations.*

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




Note: Quarterly figures are reported as a moving sum over the most recent four quarters.
*Sources: Central Bank of the Republic of Turkey, Haver Analytics and ECB staff calculations.*

For 2014, the current account deficit is foreseen to shrink, supported by a recovery in exports and a slowdown in domestic demand, but to remain at a still sizeable 6-7% of GDP. As in previous years, the financing of the current account shortfall over the first three quarters of 2013 has been mainly achieved by net portfolio investment (4.3% of GDP) and other investment (3.7% of GDP) while net foreign direct investment (1.0% of GDP) has remained modest. However, the composition of capital flows into Turkey has shifted in the course of 2013 as subsiding portfolio flows after the Federal Reserve's tapering announcement in May 2013 have been replaced with the accumulation of other investment liabilities, particularly by the banking sector. Overall, balance of payments developments up to the third quarter of 2013 implied that the CBRT accumulated additional reserve assets amounting to 1.7% of GDP although this is much lower than the 3.4% of GDP that had been recorded in the four quarters up to the first quarter of 2013.

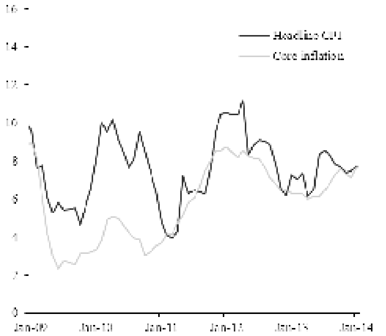
**In spite of a loosening of fiscal policy, larger-than expected revenues are anticipated to bring the general government deficit to 1.6% of GDP in 2013, an only marginal increase when compared to 2012 (-1.5% of GDP) and 0.2 percentage points below the budget target.**[45] For 2014, the medium-term economic programme foresees the public sector to record a deficit of 1.7% of GDP, but lower growth, a rise in financing costs as well as possible election-related spending slippages present a downside risk. General government debt, projected at 35.0% of GDP in 2013, seems manageable and is expected to further decrease to 33.0% of GDP in 2014.

[45] Deficit figures reported in this section are net of privatisation receipts.

*Inflation, exchange rates, monetary policy and financial stability*

**Inflation, at an annual rate of 7.7% in January 2014, has stayed above the upper (7%) bound of the CBRT's uncertainty band during most of 2013** (see Chart 1). Tax hikes, high unprocessed food inflation and, towards the latter half of the year, pass-through from the lira's depreciation (see Chart 4) were the primary factors behind this development.[46] In 2014, inflation is also widely expected to overshoot the year-end 5.0% target with latest forecasts ranging from 6.6% (CBRT) to 7.6% (February 2014 Consensus Forecast) and 8.7% (European Commission), driven by the increase of some consumption taxes at the start of 2014, larger than anticipated food price rises and further exchange rate pass-through. Even though the expected rebalancing of the economy from domestic to external demand in 2014 alleviates some price pressures, unfavourable weather conditions potentially affecting crop yields, possible hikes in (administered) energy prices and a further deterioration in inflation expectations are presenting upside risks to price stability.

**Chart 1. Consumer price inflation**
(annual percentage change)




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

**Chart 4. Nominal exchange rate**
(Turkish lira per euro)


*Source: Central Bank of the Republic of Turkey and Haver Analytics.*

**Depreciation pressures on the lira after the Federal Reserve's tapering announcement in May 2013 and in the wake of escalating domestic political tensions in late 2013 and early 2014 caused the CBRT to shift to a tightening stance as inflation expectations ran the risk of becoming unanchored.**[47] Most notably, at an extraordinary meeting on 28 January 2014 the CBRT raised its main policy rate (one-week repo rate) to 10.0% (+550 basis points), the upper end (non-primary dealer lending rate) of its interest rate corridor to 12.0% (+425 basis points) and the floor (borrowing rate) of

[46] According to CBRT estimates, each 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.
[47] By February 2014, inflation expectations had deteriorated to 8.0% (year-end 2014), 7.3% (one year ahead) and 6.6% (two years ahead) which compares with respective figures of 6.6%, 6.1% and 5.8% in February 2013.

the corridor to 8.0% (+450 basis points).[48] This (explicit) hike in the main policy rate brought (consumer price inflation-adjusted) real interest rates firmly back into positive territory and replaced a strategy of more careful tightening steps that had been implemented since May 2013. The latter was characterised by two increases in the non-primary dealer lending rate in July (+75 basis points) and August (+50 basis points) 2013 in combination with scarcer liquidity provided via the main policy rate and other facilities which guided funding costs towards the upper end of the corridor (see Chart 5). By contrast, policy before May 2013 was geared towards discouraging excessive inflows of (short-term) capital. To achieve this goal, the CBRT lowered the main policy rate by 50 basis points each in April and May 2013, yielding a cumulative reduction of 125 basis points since the beginning of 2012.[49]

**Apart from modifications to interest rates and liquidity conditions the CBRT also made expedient use of reserve requirements and the ROM as well as of direct foreign exchange operations.** Owing to financial stability considerations, reserve requirement ratios for lira and foreign currency-denominated deposits of a short-term nature were raised in the last quarter of 2012 and the first quarter of 2013 in order to make deposits with a longer maturity more attractive. In parallel, ROC on required reserves maintained in foreign currency or gold (instead of lira) by means of the ROM were increased several times to entice banks to place a larger share of the inflows of capital received from abroad during this period with the CBRT, thereby bolstering the foreign currency buffer held in their accounts at the central bank. With a changing global financing environment after May 2013 the need to absorb capital inflows was replaced with meeting banks' foreign currency requirements. To this end, foreign currency selling auctions were introduced whose size and frequency steadily rose as the year progressed.[50] At the same time, these auctions also contributed to the overall tightening of monetary conditions as they were left unsterilized. Finally, when depreciation pressures on the lira intensified in 2014 the CBRT was forced to directly intervene in the market, selling USD 3.1 billion on 23 January, its first such intervention since January 2012. In addition, a hike in ROC took effect in January 2014 with the intended outcome of reducing banks' incentive to hold mandatory reserves in foreign currency and gold instead of lira while simultaneously creating demand for lira, thus further adding to the CBRT's tighter stance.[51]

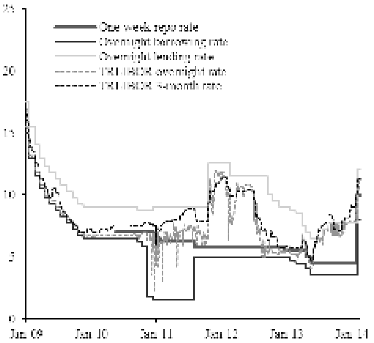
[48] At the same time, the primary dealer lending rate was adjusted to 11.5% (+475 basis points) and the rate to be paid for overnight late liquidity to 15.0% (+425 basis points).

[49] During the same period, the non-primary dealer lending rate was lowered by a cumulative 600 basis points in nine steps and the borrowing rate by a cumulative 150 basis points in four steps.

[50] From December 2013 to February 2014, the CBRT conducted 64 auctions, selling a total of USD 8.3 billion of reserves, which compares to 123 auctions for USD 12.9 billion between June 2013 (when these auctions were introduced) and November 2013.

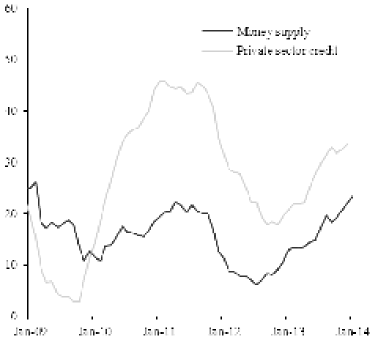
[51] The seemingly contradictory aim of using an increase of ROC to both tie up (at the end of 2012 and the beginning of 2013) and release (at the beginning of 2014) foreign currency liquidity held by banks with the CBRT illustrates the intended functioning of the ROM. If foreign capital flows are abundant it is relatively cheaper for banks to replace required lira reserves with foreign currency even if a rise in ROC renders it more costly to do so, ultimately resulting in an accumulation of foreign currency banks are placing with the CBRT. By contrast, if foreign capital is scarce higher ROC are lowering the attractiveness of using the ROM, triggering a switch from mandatory reserves maintained in foreign currency back to lira.

**Chart 5. Interest rates**
(percentages)




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

**Chart 2: Money and credit growth**
(annual percentage change)




*Note: Money supply covers M3.*
*Sources: Central Bank of the Republic of Turkey and Haver Analytics.*

**Turkey's financial sector appears resilient overall even though pockets of vulnerability exist, specifically as regards a non-negligible exposure of corporates to exchange rate risk and still buoyant loan growth, particularly in the retail segment.** Indicators of profitability and capital adequacy have remained robust but have been on declining trend since 2009, also reflecting the strong origination of credit that has taken place during this period (see Chart 6). In October 2013, return on assets and equity of Turkish banks stood at a respective 1.4% and 12.4%, compared with 1.8% and 15.5% at the end of 2012. Capital adequacy, at 12.4% in October 2013 (15.7% at the end of 2012), was comfortably above the legal minimum of 8% and the CBRT's target ratio of 12% with around 85% of capital classified as Tier-1. While the banking system has just a marginal direct foreign exchange exposure, Turkish companies maintain a noteworthy net open foreign currency position. In light of the lira's recent depreciation, this presents a potential risk for banks' asset quality although it is partly alleviated by its concentration among large companies with good credit quality that should have the ability to manage exchange rate risk and frequently have foreign currency-denominated export earnings (providing a natural hedge). In addition, credit risk from lower growth may materialise as higher unemployment could hamper the ability of households to service their debt. However, higher financing costs as a consequence of the CBRT's monetary tightening and measures implemented by the BRSA have started to dampen consumer lending towards the end of 2013 whereas non-performing loans registering at a historically low 2.7% of total loans in October 2013 are a further mitigating factor.[52]

[52] For further information on Turkey's financial sector, see the accompanying ECB document entitled "*Report on financial stability challenges in EU candidate and potential candidate countries*".

### 3. Assessment

**The improvements foreseen for the current account deficit in 2014 notwithstanding, Turkey's external vulnerabilities loom large.** The financing of the deficit is to a substantial extent achieved via inflows of portfolio investment and approximately one third of the external debt stock has to be rolled over in the near term. While short-term external liabilities of the banking sector (USD 90 billion in December 2013) were largely buffered by the USD 81 billion held by banks as foreign-currency denominated mandatory reserves via the ROM, the USD 39 billion that was owed by the non-financial private sector contrasts with the CBRT's disposable foreign currency reserves of USD 34 billion in January 2014[53]. This relatively low level of reserve coverage makes the lira vulnerable to additional bouts of selling, particularly in an environment of tighter global funding conditions, as also noted by the IMF[54]. Even though exposure to exchange rate risk seems contained among banks and households, it is not insignificant for Turkish corporations. Moreover, a further fall in the lira may exacerbate inflation that is already running considerably above the CBRT's target.

**Against this background, the CBRT has embarked on the challenging task of managing a transition from abundant to tighter global liquidity by sticking to its "flexible inflation targeting" approach.** Confronted with above target inflation and an ebbing of capital flows a cautious pace of monetary tightening was initiated after the Federal Reserve's tapering announcement in May 2013 while keeping real interest rates in negative territory, however. With the lira being subject to depreciation pressures the foreign currency liquidity needs of the economy were met by initiating foreign currency selling auctions. By following this strategy the CBRT maintained an accommodative policy stance in spite of high and rising inflation and a gradual drop in foreign exchange reserves.

**When depreciation pressures on the lira intensified in late 2013 and early 2014, partly owing to factors outside the remit of the CBRT, it decided to take additional and more resolute action, effectively resulting in a simplification of its unorthodox regime.** Notwithstanding escalating political tensions threatening to undermine foreign investor confidence and publicly aired pressure from the government to leave interest rates unchanged, the CBRT decided to aggressively tighten policy in January 2014. This move did not only result in positive real rates but also reduced the complexity of monetary policy making by unifying the main policy rate that with the actual cost of the financial sector's money market funding which had become progressively detached since the fall of 2013.

**Overall, this policy shift is welcome as it has simplified the framework within which the CBRT is operating, has put a clearer focus on its main objective of price stability and has re-asserted its**

[53] It is worth noting that the CBRT's gross foreign currency reserves, at USD 105 billion in January 2014, are considerably larger but include the foreign currency-denominated deposits held by banks as part of their mandatory reserves by means of using the ROM. Despite these assets being at the disposal of banks in the event of pressure on their foreign currency liquidity, they cannot be made available to the CBRT to defend the lira against other forms of outflows of foreign capital.
[54] See Turkey's 2013 Article IV consultation, IMF Country Report No. 13/363, December 2013.

**independence from political influence**, thereby going some way to alleviating the concerns raised in last year's assessment. Granted, "flexible inflation targeting" has had beneficial effects, such as contributing to a rebalancing of the economy in 2012 or leading to the accumulation of a sizeable stock of foreign currency liquidity banks are holding at the CBRT. Nonetheless, a verdict on the long-term success of "flexible inflation targeting" is still out. In fact, the CBRT's strategy entails non-negligible risks that were clearly demonstrated by events in January 2014 which brought the lira onto the verge of a speculative attack. Particularly the persistent failure of the CBRT to bring inflation in line with its target and anchor inflation expectations is of concern. Indeed, as already highlighted in last year's assessment, the CBRT's primary objective of maintaining price stability remains blurred by the addition of further targets that might be better addressed by prudential, fiscal or structural policies. Lastly, high inflation in combination with negligible or negative real interest rates is unlikely to raise the private sector's chronically low savings rate which is a key determinant of Turkey's significant current account deficit.

# Data appendix

**Measures of inflation, interest rates and related indicators**
(annual percentage changes unless otherwise stated)

| | FYR Macedonia | | Montenegro | | Serbia | | Turkey | |
|---|---|---|---|---|---|---|---|---|
| | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 | 2012 | 2013 |
| **Measures of inflation** *(period averages)* | | | | | | | | |
| Harmonised index of consumer prices (HICP) | 3.3 | 2.8 | 3.9 | 1.9 | ... | ... | 9.0 | 7.5 |
| National consumer price index (CPI) | 3.3 | 2.8 | 4.1 | 2.2 | 7.3 | 7.9 | 8.9 | 7.5 |
| Producer prices | 4.6 | 0.4 | 1.9 | 1.7 | 5.6 | 3.6 | 6.2 | 4.5 |
| **Interest rates** *(percentages, annual averages)* | | | | | | | | |
| Short-term policy rate [1] | 3.8 | 3.3 | ... | ... | 11.3 | 9.5 | 5.7 | 4.8 |
| Medium-term interest rate [2] | ... | ... | 8.3 | 5.5 | 15.1 | 12.5 | 8.0 | 7.6 |
| Long-term interest rate [3] | 4.9 | 3.8 | ... | ... | ... | 12.7 | 8.4 | 8.0 |
| Reference deposit rate | 3.4 | 3.1 | 3.3 | 3.1 | 6.4 | 6.4 | 7.0 | 5.3 |
| Reference lending rate | 8.0 | 7.7 | 9.5 | 9.4 | 11.8 | 11.8 | 12.5 | 9.3 |
| *Memorandum items:* | | | | | | | | |
| ECB main refinancing rate | 0.9 | 0.5 | | | | | | |
| Euro area long-term interest rate [4] | 1.6 | 1.6 | | | | | | |
| **Related indicators** *(annual percentage changes unless otherwise stated)* | | | | | | | | |
| Real GDP growth (AMECO) | -0.4 | 3.2 | -2.5 | 2.4 | -1.5 | 2.1 | 2.2 | 3.8 |
| Average monthly gross wages | 0.2 | 1.0 | 0.8 | -0.2 | 8.8 | 5.7 | 15.6 | 14.4 |
| Imports of goods and services deflator | -2.0 | -0.9 | ... | ... | 12.6 | 1.7 | 5.6 | 6.2 |
| Money supply (M2) | 4.9 | -1.2 | 3.0 | 7.6 | 10.9 | 9.5 | 7.7 | 17.6 |
| Private sector credit growth (annual averages) | 6.7 | 3.5 | -6.4 | 2.0 | 12.7 | -1.3 | 21.0 | 27.5 |

*Sources: Haver Analytics, Bloomberg, AMECO (February 2014), IMF IFS, IMF WEO (October 2013), national sources and ECB staff calculations.*
Notes: [1] For Serbia, short-term policy rate refers to 2-week repo rate. In the case of FYR Macedonia, a monthly weighted average interest rate on Central Bank Bills auctions is used (monetary policy rate). The interest rate for Turkey is the one-week repo rate. Montenegro has a unilaterally euroised economy.
[2] Annual average yield on 5 year government bonds denominated in domestic currency (or, in the case of Montenegro, in EUR).
[3] For FYR Macedonia, the rate refers to the annual average yield to maturity of a 10-year government denationalisation bond issued in May 2012 and denominated in national currency but with a euro clause. Annual average of the government bond yields for Serbia and Turkey (7 year and 10 year government bonds denominated in domestic currency for Serbia and Turkey respectively. The 7-year government bond in Serbia was issued in 2013. The Turkish 10-year government bond was issued in 2012).
[4] 10-year generic government bond yield.
Reference lending and deposit rates refer to annual averages of weighted average lending (deposit) rates granted on short- and long-term loans (deposits) to non-financial corporations and households in domestic and foreign currency (January-June/July for 2013). Average monthly gross wages for 2013 are calculated as an average of January-September 2013 for FYR Macedonia, annual averages for the other three countries.

**Macroeconomic projections**
(as a percentage of GDP unless otherwise stated)

| | FYR Macedonia | | Montenegro | | Serbia | | Turkey | |
|---|---|---|---|---|---|---|---|---|
| | 2014 | 2015 | 2014 | 2015 | 2014 | 2015 | 2014 | 2015 |
| **Real GDP growth (%)** | | | | | | | | |
| IMF/WEO | 3.2 | 3.6 | 2.2 | 2.3 | 2.0 | 2.2 | 3.5 | 4.3 |
| EC/AMECO | 2.5 | 2.6 | 2.7 | 3.0 | 1.3 | 2.2 | 2.5 | 3.0 |
| **Current account balance** | | | | | | | | |
| IMF/WEO | -6.2 | -5.6 | -16.2 | -16.3 | -6.5 | -7.8 | -7.2 | -7.4 |
| EC/AMECO | -2.6 | -3.0 | -15.3 | -15.8 | -4.7 | -4.8 | -6.5 | -4.4 |
| **General government net lending** | | | | | | | | |
| IMF/WEO | -3.4 | -3.4 | -3.2 | -3.3 | -6.2 | -6.5 | -2.3 | -2.3 |
| EC/AMECO | -3.8 | -3.6 | -2.5 | -1.1 | -5.9 | -5.2 | -2.9 | -2.5 |
| **General government gross debt** | | | | | | | | |
| IMF/WEO | 35.0 | 35.7 | 54.3 | 55.2 | 71.3 | 74.3 | 34.9 | 33.5 |
| EC/AMECO | 37.4 | 38.9 | 57.9 | 59.0 | 70.0 | 72.8 | 36.7 | 36.2 |
| **Inflation (CPI change, %)** | | | | | | | | |
| IMF/WEO | 2.0 | 2.0 | 2.3 | 2.3 | 4.8 | 4.0 | 6.0 | 6.0 |
| EC/AMECO | 3.3 | 3.0 | 2.3 | 2.6 | 4.3 | 5.0 | 8.7 | 7.4 |

*Sources: AMECO (February 2014) and WEO (October 2013).*