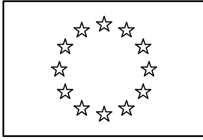

EUROPEAN COMMISSION
DIRECTORATE GENERAL
ECONOMIC AND FINANCIAL AFFAIRS

2012 PRE-ACCESSION ECONOMIC PROGRAMMES OF CROATIA, ICELAND, THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA, MONTENEGRO, SERBIA AND TURKEY:

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1 HORIZONTAL OVERVIEW

1.1 BACKGROUND

Croatia, Iceland, the former Yugoslav Republic of Macedonia, Turkey and, for the first time, Montenegro were invited to submit their annual *Pre-accession Economic Programmes* (PEPs) covering the period 2012-2014. Serbia submitted an Economic and Fiscal Programme (EFP). However, as the country was granted candidate status by the European Council's decision of 1-2 March 2012, its EFP is being presented and assessed together with the five PEPs. Countries were requested to submit their programmes by 31 January 2012. All countries except Croatia complied with this deadline. All six programmes have been made public.[1]

The programmes provide a medium-term macroeconomic and fiscal scenario as well as an overview of economic policy plans over a broad range of issues. In particular, they show the governments' intentions to further advance structural reforms, enhance productivity and align with the EU's *acquis* and best practices with a view to achieving high growth in order to catch up with, and prepare for EU membership.

1.2 THE 2012 PROGRAMMES

The programmes were prepared against a background of deteriorating EU and global economic conditions which, although they have stabilised in recent months, remain uncertain. The exposure of candidate countries to the EU and specifically to euro area economies implies that external shocks can be transmitted at varying degrees through the financial, remittances and trade and investment channels. Iceland, Montenegro, Serbia and Turkey foresee a slowdown in GDP growth in 2012 before rebounding in 2013-14. The macroeconomic frameworks of Croatia and the former Yugoslav Republic of Macedonia are in line with last year's programmes, expecting a positive economic growth in 2012 and a further acceleration in the outer years. Although the fiscal frameworks of all countries foresee a continuous decline in fiscal deficits, compared to last year's vintage the budget consolidation is less ambitious. Montenegro and Iceland project a balanced budget by 2013, instead of in 2012 foreseen in the previous programme. Like in previous submissions, the structural reform agendas reveal a varying focus and degree of ambition.

The Presidency's conclusions of the Ministerial dialogue between EU Member States and candidate countries of 17 May 2011 called to progressively adapt the Pre-accession Economic Programmes to the strengthened economic governance in the EU. Therefore, candidate countries were asked by the Commission – as a first step – to put more emphasis in their 2012 programmes on the assessment of the sustainability of the

[1] Croatia: http://www.mfin.hr/adminmax/docs/ENG_PEP%202012-2014.pdf
The former Yugoslav Republic of Macedonia:
http://www.finance.gov.mk/files/u1/pre_accession_economic_programme_2012_2014.pdf
Iceland: http://eng.efnahagsraduneyti.is/media/Acrobat/Pre-ccessionEconomicProgramme2012_FINAL.pdf
Montenegro: http://www.mf.gov.me/en/news/111256/MONTENEGRO-PRE-ACCESSION-ECONOMIC.html
Serbia: http://www.mfin.gov.rs/UserFiles/File/dokumenti/2012/EFP%20SR%202012.pdf
Turkey: http://ekutup.dpt.gov.tr/ab/kep/PEP_2012-2014.pdf

external position and on the main structural obstacles to growth, in line with the Europe 2020 strategy.

Pre-Accession Economic Programmes 2012
Key indicators

	2008	2009	2010	2011e	2012	2013	2014
Real GDP growth (% change)							
Croatia	2.2	-6.0	-1.2	0.4	0.8	1.5	2.5
Iceland	1.3	-6.7	-4.0	2.6	2.4	2.5	2.8
The former Yugoslav Republic of Macedonia	5.1	-0.9	1.8	3.5	3.0-4.0	3.5-4.2	4.0-4.7
Montenegro	6.9	-5.7	2.5	2.5	2.0	3.5	4.0
Serbia	3.8	-3.5	1.0	2.0	1.5	3.0	4.0
Turkey	0.7	-4.8	9.0	7.5	4.0	5.0	5.0
Unemployment rate (%, LFS)							
Croatia	8.4	9.1	11.8	13.3	14.0	14.0	13.4
Iceland	2.3	3.0	8.4	7.6	6.4	5.8	5.4
The former Yugoslav Republic of Macedonia	33.8	32.2	32.0	30.8	30.1	29.2	28.1
Montenegro	16.8	19.1	19.7	19.5	18.5	16.8	14.9
Serbia	13.6	16.1	20.0	23.2	22.9	22.0	20.8
Turkey	11	14.1	12.0	10.5	10.4	10.2	9.9
Current account balance (% of GDP)							
Croatia	-8.9	-5.3	-1.2	0.2	0.0	0.5	1.1
Iceland	-24.5	-11.7	-11.2	-9.3	-4.1	-1.7	-2.4
The former Yugoslav Republic of Macedonia	-12.8	-6.8	-2.2	-4.8	-4.8	-4.6	-3.7
Montenegro	-51.3	-30.1	-25.3	-22.8	-21.7	-20.8	-19.7
Serbia	-20.6	-7.4	-7.2	-7.5	-8.4	-7.7	-7.4
Turkey	-5.6	-2.3	-6.4	-9.4	-8.0	-7.5	-7.0
Inflation (CPI, annual % change)							
Croatia	6.1	2.4	1.1	2.3	2.4	2.5	2.4
Iceland	12.7	12.0	5.4	4.0	4.2	2.9	2.5
The former Yugoslav Republic of Macedonia	8.3	-0.8	1.6	3.9	2.5	2.5	2.5
Montenegro	7.4	3.4	0.5	2.0	2.0	2.0	2.0
Serbia	8.6	6.6	6.5	11.2	4.1	3.7	4.0
Turkey	10.4	6.3	8.6	5.9	6.6	5.0	4.9
General government balance (% of GDP)							
Croatia	-1.4	-4.1	-4.9	-5.6	-3.8	-3.3	-2.6
Iceland	-13.5	-9.9	-10.1	-3.4	-1.4	0.0	1.2
The former Yugoslav Republic of Macedonia	-1	-2.7	-2.5	-2.5	-2.5	up to -2.5	up to -2.5
Montenegro	0.5	-4.4	-4.9	-3.2	-1.0	0.1	1.0
Serbia	-2.6	-4.5	-4.6	-4.6	-4.3	-3.7	-2.9
Turkey	-2.2	-5.7	-2.9	-1.0	-0.8	-0.8	-0.4
General government debt (% of GDP)							
Croatia	28.9	35.2	41.3	44.9	47.2	48.9	49.4
Iceland	70.4	106.6	92.9	98.4	93.2	89.4	84.8
The former Yugoslav Republic of Macedonia	28.8	32.1	24.6	27.0	28.8	up to 28.8	up to 28.8
Montenegro	29	38.2	40.9	43.8	46.9	45.4	42.9
Serbia	25.6	31.3	42.7	42.4	44.0	44.9	44.4
Turkey	39.5	45.5	42.2	39.8	37.0	35.0	32.0

Source: Pre-Accession Economic Programme (PEP) 2012 for 2010-2014, CCEQ for 2008 and 2009

The 2012 PEPs reveal that candidate countries still had difficulties to fully adhere to the requested alignment of their programme, and in particular to provide a more forward looking assessment on external sustainability and growth-enhancing structural reforms.

According to the programmes, all candidate countries registered positive economic growth in 20112, varying from 0.4% in Croatia to 7.5% in Turkey. Iceland's GDP growth is estimated at 2.6% following two consecutive years of output contraction. The pace of real GDP growth doubled in the former Yugoslav Republic of Macedonia to 3.5% and in Serbia to 2%. For Montenegro, economic growth remained unchanged at 2.5%.

For 2012, most countries expect to register lower, but still positive economic growth. Turkey is set to post a sharp deceleration in real GDP growth to 4% before increasing to 5% in the outer years. Similarly, a slower pace of real GDP growth is foreseen in Iceland, Montenegro and Serbia. Iceland's PEP anticipates growth at 2.4% in 2012, thereafter accelerating to 2.8% by the end of the programme period. For Montenegro, economic activity is set to decelerate to 2% in 2012 before picking up in the outer years, reaching 4% by 2014. Following a slowdown in real output to 1.5% in 2012, Serbia's

[2] Since the submission of the PEPs, revised real GDP growth data for 2011 have been published as follows: Croatia - 0.0%, the former Yugoslav Republic of Macedonia 3.0%, Iceland 3.1%, Serbia 1.6%, Montenegro (Central Bank estimates) 3% and Turkey 8.9%.

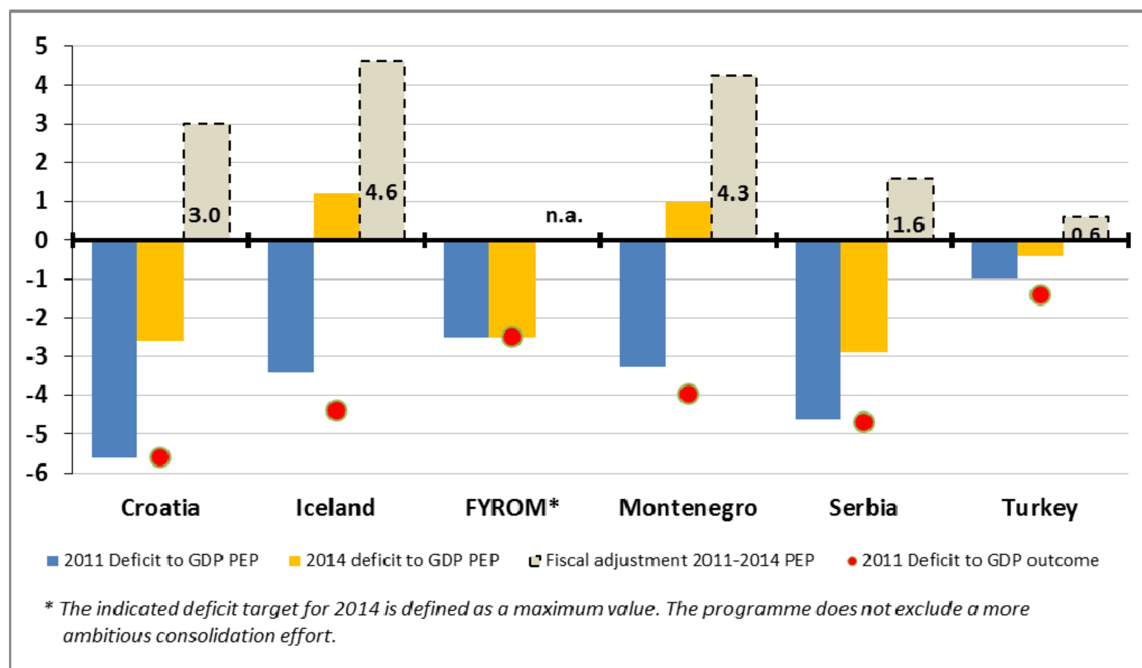
programme assumes an acceleration in economic activity reaching 4% by 2014. Croatia's PEP foresees steadily increasing economic growth from 0.8% in 2012 to 2.5% by the end of programme period. Economic growth in the former Yugoslav Republic of Macedonia is forecast to be between 3-4% in 2012 and to accelerate to 4-4.7% by 2014.

All programmes except Serbia's envisage domestic demand to be the main driver of economic growth, primarily as a result of private consumption and investment. Serbia foresees a more balance growth outlook with the contribution of net exports increasing over the medium-term. Current account balances are set to improve in general, although at different speeds with Croatia projecting a growing surplus over the programme's horizon. Overall, the programmes' macroeconomic scenarios still tend to be somewhat on the optimistic side and face downside risks which include a worsening external economic situation, slow progress with household and corporate debt restructuring, heightened inflationary pressures and the slowdown of capital inflows, notably workers' remittances and FDI inflows.

All candidate countries with the exception of the former Yugoslav Republic of Macedonia project a reduction in the budget deficit over the programme period. Iceland anticipates the largest improvement in the fiscal balance from a deficit of 3.4% of GDP to a surplus of 1% by 2014, equivalent to an adjustment of almost 4.6 percentage points of GDP. Montenegro is also projecting a budget surplus of 1% of GDP in 2014 from a deficit of 3.2% in 2012, an adjustment of 4.2 percentage points of GDP. For Croatia, the government deficit is set to decline by 3 percentage points of GDP, from 5.6% of GDP in 2011 to 2.6% in 2014, while Serbia's fiscal deficit is foreseen to decline steadily from 4.6% of GDP in 2011 to 2.9% in 2014. In the case of Turkey, the government deficit is set to fall from 1% of GDP to 0.4% by the end of the programme period. The programme of the former Yugoslav Republic of Macedonia anticipates a deficit of up to 2.5% of GDP over the period 2011-2014.

For all countries, the fiscal adjustment will primarily be driven by a reduction in the expenditure-to-GDP ratio. However, providing more detailed information about the specific underlying policy measures would certainly improve the credibility of the fiscal programmes. The PEPs of Serbia and Turkey project lower public consumption as the main source for the fiscal adjustment. Although the budget consolidation in Iceland seems to be expenditure-led, the measures spelled out in the PEP are mostly on the revenue side. Cuts in the public wage bill, health care spending, subsidies and public investment are set to be the main drivers of a lower expenditure ratio for Croatia, while Montenegro's budgetary consolidation will be underpinned by a decline in the public sector salaries-to-GDP ratio. The sequencing of the fiscal adjustment within the programme period varies across countries. For Croatia, Iceland and Montenegro, the deficit adjustment is front-loaded taking place primarily in 2012. Serbia and Turkey's consolidation is back-loaded and is assumed to accrue mostly in 2014.

Budgetary developments
(percent of GDP)



Similar to previous years, the structural reform agendas spelled out in the PEPs reveal a varying focus and degree of ambition and would benefit from being based more strongly on an analysis of the structural bottlenecks to growth as requested by the Commission for the 2012 PEPs. All programmes fail to identify and analyse in a forward-looking way the structural obstacles to growth as requested by the Commission. They would in general have benefited from a closer link between reform measures and the fiscal framework. The reform priorities and their alignment with accession-related priorities, as described in the Commission's progress reports, Opinion and the European Partnership documents appear to be addressed at varying degrees by the programmes.

For Croatia, the programme would have benefited from more emphasis on the measures urgently needed to improve the business climate in view of the significant administrative and regulatory obstacles. Iceland's structural reform framework as presented in the programme is coherent, however the level of detail for some of the measures is insufficient while a clear timeline and sequencing of the planned measures, along with information about their estimated budgetary impact is missing. Although the programme of the former Yugoslav Republic of Macedonia presents a wide array of intended policy measures in a broad range of areas, the steps to be taken and their expected outcomes are not explicitly spelled out. Montenegro's structural reforms package covers a wide range of areas but several measures, including labour law, pension reform and financial sector relate to the continuation of previous initiatives and focus on the development of secondary legislation. While Serbia's programme acknowledges the need to step up structural reforms by, amongst others, strengthening further the rule of law, completing privatisation and enhancing the business environment, it fails to provide convincing action plans as regards the medium-term priorities. The structural reforms in Turkey's PEP cover a broad range of issues, although they are insufficiently linked to the fiscal

scenario and are only partly aligned with accession-related priorities. Similar to previous submissions all programmes often put emphasis on past developments and would benefit from elaborating more on future plans. In addition, the links between the structural reforms and the macroeconomic and fiscal frameworks are not always clearly discussed. The full and determined implementation of the proposed reforms should strengthen the economies of the candidate countries and support deeper integration with the EU.

1.3 COUNTRY-SPECIFIC SUMMARY

Croatia's PEP presents a comprehensive, albeit optimistic, medium-term macroeconomic scenario projecting a gradual recovery from the recession that hit the economy in the previous years. Output growth is set to increase gradually from 0.8% in 2012 to 2.5% by 2014 mainly on the back of domestic demand. The programme projects inflation to remain stable at around 2.4% and a small current account surplus. The analysis of external sustainability and of competitiveness is limited. The budgetary strategy remains oriented towards fiscal consolidation which the PEP expects to achieve through an expenditure-led reduction in the deficit, slowing the upward trend of general government debt in the process. The fiscal framework is consistent with the macroeconomic scenario, but there are significant risks surrounding the achievement of the deficit targets notably related to lower-than-anticipated economic growth, implementation risks of the expenditure-reducing measures which the PEP fails to identify and explain, and the financing costs for the public debt. The structural obstacles to growth are not identified and analysed in the programme. The presentation of structural reforms is mainly backward-looking. While the PEP contains estimates of the budgetary cost of some measures, it fails to establish a clear link between the structural reform agenda and the implementation of the fiscal strategy.

Iceland's PEP presents a broadly plausible growth scenario anticipating a modest recovery primarily driven by private consumption, investment and exports. Inflation is expected to peak in 2012 and ease thereafter to reach the inflation target of 2.5% by 2014, although risks are high over the medium-term. The current account, adjusted for the net factor income of banks in winding-up proceedings, is expected to turn into a surplus and stay positive over the programme period. The programme does not provide an analysis of the current account sustainability and of competitiveness. The fiscal framework presented in the programme projects a continuation of budgetary consolidation which is set to lead to a balanced budget in 2013 and a surplus in 2014. The expenditure-led fiscal adjustment is ambitious and front-loaded. However, while the consolidation seems to be expenditure-led, as the spending to GDP ratio is planned to fall markedly, this adjustment pattern is not sufficiently reflected by the choice of underlying fiscal measures, which are mostly on the revenue side. Moreover, the proposed consolidation path counts very much on temporary non-tax revenues and some measures remain unspecified or have not been legislated. The credibility of the fiscal programme could be strengthened by providing more information about the policies supporting the medium-term budgetary framework. The programme identifies the still precarious financial sector situation and high household and corporate indebtedness as the major obstacles to a sustainable recovery. Although the PEP addresses a broad range of structural challenges, the level of detail in presenting key policy measures is insufficient and could be improved. Moreover, the link between the structural reform priorities and the realisation of the fiscal targets is not sufficiently clear.

The former Yugoslav Republic of Macedonia programme's main objective is to improve the country's competitiveness by a broad range of measures. The PEP's optimistic macroeconomic scenario is presented in the form of annual ranges which project economic growth to rise from 3-4% in 2012 to 4-4.7% by 2014 led primarily by private consumption and investment. Inflation is foreseen to remain benign, while strong employment growth will lead to a lower jobless rate. The programme fails to provide an analysis of the current account and of competitiveness issues. The fiscal deficit is projected to reach up to 2.5% of GDP over the programme period which, although feasible, is based on optimistic assumptions on output and revenue growth assumptions. Tax rates are planned to remain unchanged while a reduction in social contributions is expected to reduce the tax wedge. Current spending, with the notable exception of subsidies to agriculture, is assumed to decline markedly while capital outlays are set to rise as a share of GDP. The PEP does not explicitly elaborate on structural bottlenecks to growth while most of the reforms presented are rather backward looking. The programme would have benefited from a clearer link between the identified obstacles and policy measures and by spelling out in more detail the reform measures and intended targets.

Montenegro's baseline macroeconomic framework foresees a weakening of economic growth in 2012 (2%) and a sustained acceleration over the programme horizon. However, in light of the uncertain global economic situation the likelihood of the low-growth alternative scenario presented in the programme has increased significantly. Following the significant decline in the current account deficit in 2011, the PEP anticipates a moderate improvement of external imbalances over the medium term. The programme does not analyse the sustainability of the external sector and of competitiveness issues. The fiscal strategy aims at achieving a balanced budget in 2013 and a surplus in 2014, through a front-loaded reduction in the expenditure ratio. The deteriorating external environment, increasing liabilities from state guarantees and tax arrears suggest that achieving these budget targets may be unrealistic. The programme fails to identify and analyse the structural obstacles to growth. It covers a broad range of structural reform areas, focusing on further development of reforms already engaged.

Serbia's programme presents an optimistic macroeconomic scenario, especially for 2012, when GDP growth is projected to reach 1.5% and accelerate to 4% by 2014. The current account deficit is expected to widen further while inflation is set to fall sharply to some 4% in 2012 and fluctuate around that level in the outer years. The programme does not provide a forward-looking assessment of the external account sustainability and of competitiveness and would have benefited from presenting an alternative macroeconomic scenario. The fiscal deficit is projected to decline gradually in the medium term and reach 3% by 2014. The budgetary consolidation is planned to be achieved by restraining current expenditure, specifically pension and payroll spending as well as government consumption, as a share of GDP. The plausibility of the targets is constrained by the outdated macroeconomic scenario. The programme would have benefited from a more thorough analysis of bottlenecks to economic growth and from a better elaboration of the structural strategy. Roadmaps and timetables for the implementation of key reform measures, as well as assessments of their budgetary impact, are largely missing.

The Turkish PEP presents a comprehensive and broadly consistent medium-term macroeconomic framework. Real GDP growth is expected to slow to 4% in 2012 down from 7.5% last year before accelerating to around potential of 5% in the outer years

driven mainly by investment and to a lesser extent private consumption. The programme projects an improved current account deficit and easing inflationary pressures in the medium-term, which appear rather optimistic. The analysis of external sustainability and of competitiveness is limited. The fiscal strategy is characterised by a continued gradual reduction of the budget deficit, although the PEP does not elaborate on the underlying measures that would support the consolidation. The programme fails to identify and analyse the structural obstacles to growth. The structural reforms appear to be appropriate as they aim at enhancing the competitiveness of key economic sectors. Nevertheless, concrete implementation measures and timetables remain vague and their budgetary impact is not always elaborated.

This exercise of submitting, assessing and discussing annual PEPs will continue to support the countries in preparing for accession. A further integration of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy formulation, in particular the economic chapters of the Progress Reports and Accession Partnerships and the bilateral economic dialogues with the countries, can enhance the EU's effectiveness in this respect.

1.4 THE PEPS AND PRE-ACCESSION STRATEGY

The ECOFIN Council of 26-27 November 2000 requested the Commission to invite candidate countries to submit an annual PEP and an annual fiscal notification. This initiative resulted in the so-called Pre-Accession Fiscal Surveillance Procedure, which aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the EMU. The PEPs are part of this procedure. Since 2001, acceding and candidate countries have submitted such annual medium-term PEPs, comprising notably of a macro-economic scenario, a fiscal framework and a structural reform agenda.

The assessment of these programmes complements the policy messages given by the Commission in its annual Enlargement Package. While the economic chapters of the latter assess only past developments in the countries, the assessments of the PEPs are forward looking. They analyse government medium-term plans, crucial for eventual full compliance with the Copenhagen economic criteria for accession.

The PEPs are important platforms for the authorities to develop and communicate consistent economic, fiscal and structural policies over the medium term. Their preparation serves a twofold purpose: to strengthen economic planning capacity in the countries as such and to specifically prepare them for participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure. The PEPs and their assessments are therefore discussed in a multilateral policy framework with Member States and candidate countries, ending with the annual policy dialogue of the ECOFIN Council with candidate countries.

The experience with the PEPs has shown that the positive results in terms of building up administrative and policy planning capacity and of designing conducive and consistent policies are powerful, but that they take time to accumulate and to materialise.

The programmes lay out policy strategies which are to a large degree compatible with and conducive to the economic priorities of the Accession Partnerships and, more widely, to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raising competitiveness to a level which would allow the countries to meet competitive pressure within the European Union.3 However, the programmes would have benefited from clearer and more convincing information on the specific implementation of these objectives. Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.5 FOLLOW-UP

The programmes and their assessments by the Commission services will be discussed within multilateral policy dialogues between Member States and candidate countries. A special meeting of the Alternates of the Economic and Financial Committee with representatives of candidate countries will take place on 27 April 2012 to discuss and assess the individual programmes. On 4 May, a High-level meeting between the EFC and representatives of the candidate countries will be held and the draft conclusions prepared at the Alternates level will be endorsed. The Ministerial Meeting between the ECOFIN and their counterparts from the candidate countries is scheduled for 15 May 2012 and intends to adopt and publish the conclusions on the programmes of the Candidate Countries.

This annual exercise will be repeated again next year when countries will be invited to submit a programme covering the period 2013-2015.

[3] So far, the Commission considers Croatia, Iceland and Turkey to have achieved the status of a functioning market economy, while the former Yugoslav Republic of Macedonia is seen to be well advanced as regards meeting the economic criteria and to have continued to move closer towards becoming a functioning market economy. Montenegro has made further progress towards a functioning market economy as a result of progress in stabilising the banking sector and maintaining a relatively prudent fiscal stance. Similarly, Serbia has taken important steps towards establishing a functioning market economy and achieved a certain degree of macroeconomic stability, although further efforts will be necessary for restructuring the economy.

2 CROATIA

2.1 EXECUTIVE SUMMARY

Croatia's eight Pre-Accession Economic Programme ("PEP 2012-2014") presents a comprehensive, though optimistic, medium-term macroeconomic and fiscal framework based on the projection of a gradual recovery from recession and stagnation in the preceding years. The programme's fundamental objective is to establish a knowledge-based, export-oriented and competitive economy in which output and employment expand and social cohesion is maintained. The document largely complies with the formal requirements and appears consistent with the 2012 state budget which was adopted on 24 February 2012.

Macroeconomic performance in 2011 was characterised by a stabilisation of the output level following the contraction in 2008-2010. Real GDP still declined in the first quarter, then started to expand in the second and third quarters, before contracting again in the final quarter. Annual GDP is estimated to have stagnated (-0.0%) in real terms compared to 2012. However, employment continued to fall, pushing up the unemployment rate by 1.7 percentage points. Consumer price inflation rose to an annual average of 2.3% mainly as the result of higher commodity prices, particularly in the food segment. The current account deficit remained unchanged compared to the preceding year at 1% of GDP. Gross external debt, a major challenge for macroeconomic policies, also remained stable at just above 100% of GDP over the course of the year. The fiscal deficit of general government had been planned to be 5.6% of GDP and, according to preliminary information from the Ministry of Finance, this budgetary target has been broadly met.

Looking forward, the PEP projects a macroeconomic scenario for 2012-2014 with moderate output growth and relatively low inflation. Real GDP is seen to accelerate gradually from 0.8% growth in 2012 to 2.5% in 2014. In view of this relatively optimistic projection, the programme would have benefited from a broader assessment of risks associated with a lower growth profile. The unemployment rate is projected to rise to 14% in 2012 and only starts to recede from this level in 2014. Consumer price inflation is expected to remain relatively stable at around 2.4%. A small current account surplus is projected until the end of the projection period in spite of the resumption of growth. External debt is projected to decline gradually to around 95% of GDP by 2014. It would have been appropriate to include a sustainability analysis for the external debt in view of its very high level and the risk that the projected current account surpluses will not materialise. Similarly, the programme could usefully have included a presentation of Croatia's price and cost competitiveness including an account of the development of export market shares. Overall, the macroeconomic scenario is optimistic regarding output growth in the near term and the current account development.

The "PEP 2012-2014", which reflects the 2012 state budget as adopted in February 2012, plans a significant expenditure-led consolidation of general government finances over the programme period. The adjustment is frontloaded in 2012 when the share of total expenditures in GDP is planned to be reduced by 1.9 percentage points and net borrowing by 1.7 percentage points to 3.8% of GDP. Subsequently, the fiscal deficit is projected to fall more moderately to 3.3% of GDP in 2013 and 2.6% in 2014. Realising these deficit targets will face considerable hurdles and require a determined and sustained

effort to rein in expenditures through the swift adoption of appropriate cost saving measures. It will be highly challenging to implement the envisaged cuts in the public wage bill, health care costs and subsidies, particularly already in the current fiscal year. Furthermore, meeting the fiscal deficit targets requires a return to at least moderate GDP growth. The projected fiscal outcomes would have been more convincing, if the supporting measures had been made more explicit. The PEP provides a sensitivity analysis which indicates the budgetary consequences of alternative scenarios where growth disappoints and no further consolidation efforts are made. However, if the baseline scenario was realised, Croatia would comply with its Fiscal Responsibility Law and move closer to achieving medium-term fiscal sustainability.

Structural obstacles to growth are not appropriately identified, but only alluded to indirectly in the PEP. The programme covers a range of structural reform areas, particularly product and labour markets, various industry and utility sectors, finance, agriculture, public administration, education, health care, social security, the judiciary and environmental protection. The presentation is often backward looking, providing information on past and on-going reform measures and initiatives with a strong emphasis on legislative action and EU harmonisation. The programme does not fully and consistently establish a clear link between the core objectives and the instruments and measures described. To serve as useful guidance for a structural reform agenda, the programme would benefit from the definition of clear objectives, specific measures and concrete time frames for implementation. More emphasis should have been given to measures urgently needed to improve the business environment in view of the significant regulatory and administrative obstacles still in place. The programme contains fiscal estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy is generally weak. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would help to increase the economy's growth potential and international competitiveness over the medium and longer term.

There are significant risks associated with various parameters of the PEP. The macroeconomic scenario is considerably more optimistic regarding GDP growth than the current consensus which expects a contraction in 2012. The downside risks to the PEP's growth projection are accentuated by the recent deterioration in the outlook for major export markets and the current oil price level. There is separate risk that the current account deficit may widen substantially if growth should develop as projected in the PEP. The fiscal scenario is, apart from disappointing growth, associated with a risk from a failure to take the concrete measures required to cut or restrain expenditure in line with projections and with a risk that the financing of the public debt will be more costly than projected. Regarding structural reforms, there is a general risk that the slow pace of the reform process in recent years will continue. This would undermine both fiscal consolidation and macroeconomic performance.

Comparison of key macroeconomic and budgetary projections		2010	2011	2012	2013	2014
Real GDP growth (% change)	COM	-1.2	0.6	0.8	1.2	n.a.
	PEP 2012	**-1.2**	**0.4**	**0.8**	**1.5**	**2.5**
Consumer price inflation (%)	COM	1.1	2.1	1.5	1.7	n.a.
	PEP 2012	**1.1**	**2.3**	**2.4**	**2.5**	**2.4**
General government balance (% of GDP)	COM	-4.9	-5.5	-5.4	-5.2	n.a.
	PEP 2012	**-4.9**	**-5.6**	**-3.8**	**-3.3**	**-2.6**
Primary balance (% of GDP)	COM	-2.9	-3.3	-2.2	-1.5	n.a.
	PEP 2012	**-2.9**	**-3.4**	**-1.5**	**-1.3**	**-0.8**
Government gross debt (% of GDP)	COM	41.2	45.8	50.0	53.8	n.a.
	PEP 2012	**41.3**	**44.9**	**47.2**	**48.9**	**49.4**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission autumn 2011 forecast (COM)

2.2 INTRODUCTION

Croatia submitted its eight Pre-Accession Economic Programme on 1 March 2012. The programme covers the period 2012-2014. It was prepared in conjunction with the state budget for 2012 and the budget projections for the two following years. Due to the parliamentary elections in December 2011 the budget was first adopted on 24 February 2012.

2.3 KEY CHALLENGES

The key challenge for Croatia's economic policy is to provide the conditions for sustainable growth while preserving macroeconomic stability. This requires a strengthening of the economy's international competitiveness through internal structural reforms as macroeconomic policy is heavily constrained by the large external debt and the need for fiscal consolidation. The process of fiscal consolidation requires significant expenditure reforms with a view to restructure current spending towards a more growth-oriented and sustainable pattern. The stagnation of economic activity over the past two years is a clear indication of structural weaknesses which need to be tackled urgently. The required measures are, in particular, the swift and effective implementation of growth-enhancing reforms in areas such as privatisation and corporate sector restructuring, labour market, business environment, social security, education, and public administration.

As pointed out in the Commission's most recent Progress Report on Croatia's accession process which refers to the period from October 2010 to September 2011, the speed of structural reforms remained slow, not least with respect to privatisation and the restructuring of loss-making enterprises. The investment climate continued to suffer from a heavy regulatory burden and numerous non-tax fees. Planned reforms of the highly rigid labour market were narrowly circumscribed and the already low employment and participation rates declined further. Social transfer payments, which represent a relatively high share of public budgets, remained not well-targeted. Considering the need to achieve medium-term fiscal sustainability, the budgetary process could be improved further. Enhancing the efficiency of public spending remains a key challenge.

2.4 RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

2.4.1 Recent macroeconomic developments

The PEP covers recent macroeconomic developments appropriately taking into account that the complete GDP estimates for 2011 were released after the submission date. Following the sharp contraction of Croatia's output during the global economic and financial crisis in 2008/09, the output decline levelled off in 2010. Over the three-year period between the first quarter of 2008 and the first quarter of 2011 the level of real GDP shrank close to 10%. GDP expanded slightly in the second and third quarter of 2011, but started to recede again in the fourth quarter like in many EU Member States. Croatia's annual average growth in 2011 turned out to be zero, i.e. far below the projection in last year's PEP (1.5%). An analysis of GDP components reveals that final domestic demand continued to contract in 2011, particularly due to a further drop in investment activity (-7.2%). Private consumption was slightly positive (+0.2%), but this was partly offset by lower public consumption (-0.2%). The level of real GDP was held up by inventory accumulation which contributed 1.1 percentage points to growth. Net exports added 0.4 percentage points to GDP growth as exports of goods and services expanded faster (+2.2%) than imports (+1.0%).

The current account deficit corresponded to 1.0% of GDP in 2011 which is unchanged from the preceding year.[4] The sharp adjustment from current account deficits of 8.9% of GDP in 2008 and 5.0% in 2009 is exclusively the result of declining domestic demand (expenditure reduction) and does not reflect an improvement of international competitiveness.

Inflows of foreign direct investments in 2011 remained far below the pre-recession level. Nevertheless, net FDI was higher than in 2010 helped by retained earnings by already established foreign companies. The labour market continued to weaken in 2011 as declining employment pushed up the unemployment rate to an annual average of 13.5%. Although underlying inflationary pressures remained low, annual consumer price inflation rose to 2.3% as a consequence of higher commodity prices, particularly in the food segment.

[4] This is based on the official current account data in euro. The current account deficit expressed in the domestic currency was 0.8% of GDP both in 2010 and in 2011.

Comparison of macroeconomic developments and forecasts

	2010		2011		2012		2013		2014	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	-1.2	**-1.2**	0.6	**0.4**	0.8	**0.8**	1.2	**1.5**	n.a.	**2.5**
Contributions:										
- Final domestic demand	-3.4	**-3.4**	-1.1	**-1.4**	0.0	**0.8**	1.6	**0.7**	n.a.	**1.6**
- Change in inventories	-0.4	**-0.4**	0.4	**0.4**	0.2	**0.1**	0.1	**0.0**	n.a.	**0.1**
- External balance of goods and services	2.6	**2.6**	1.4	**1.4**	0.6	**-0.1**	-0.5	**0.7**	n.a.	**0.7**
Employment (% change)	-4.0	**-4.0**	-4.0	**-3.1**	-0.1	**-1.3**	0.6	**0.1**	n.a.	**0.8**
Unemployment rate (%)	11.8	**11.8**	13.6	**13.3**	13.2	**14.0**	12.4	**14.0**	n.a.	**13.4**
GDP deflator (% change)	1.0	**1.0**	1.7	**2.3**	1.9	**1.3**	1.8	**2.2**	n.a.	**2.4**
CPI inflation (%)	1.1	**1.1**	2.1	**2.3**	1.5	**2.4**	1.7	**2.5**	n.a.	**2.4**
Current account balance (% of GDP)	-1.2	**-1.2**	-1.2	**0.2**	-0.6	**0.0**	-1.4	**0.5**	n.a.	**1.1**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission autumn 2011 forecast (COM)

2.4.2 Medium-term macroeconomic scenario

The PEP 2012-2014 presents a comprehensive medium-term macroeconomic scenario with projections for key economic variables, covering GDP and its demand components, employment and wages, inflation as well as balance of payments developments.

Like in the previous PEP, the projected path of GDP growth is upward-sloping, reaching 2.5% in the last programme year. But, following disappointing GDP performance in 2011, the growth rates in the first two programme years (2012 and 2013) have been lowered. Nevertheless, the 0.8% growth rate projected for 2012 seems unrealistic and an outlier compared to practically all other comparable forecasts. While this projection is in line with the Commission's autumn 2011 forecast, it does not seem to take into account the renewed weakening of Croatia's growth performance since then, in the last quarter of 2011 and in early 2012. By pointing to a number of substantial downside risks to its growth forecast, but not to any upside risks, the PEP seems to admit implicitly that the 2012 growth forecast is unlikely to be achieved.

The external assumptions of the PEP 2012-14 have changed compared to previous years' programme in a direction unfavourable to Croatia's economy. EU and global GDP growth have been lowered significantly and the oil price has been increased. Projections for world trade are not provided any more.

Real sector

The PEP projects that the Croatian economy will revert to positive annual growth rates in the programme period following the contraction in 2009-2010. Real GDP is set to accelerate moderately from 0.8% growth in 2012 to 1.5% in 2013 and 2.5% in 2014. In 2012, the resumption of growth will be driven by a strong surge in investments by public enterprises. Investments by the private sector and by general government are not expected to contribute significantly to the 7.4% rise in overall fixed capital formation. Change in inventories is expected to contribute with 0.1 percentage point to overall GDP growth in 2012. Private consumption is expected to recede by 0.3% reflecting a decline in household real disposable income which, in turn, is seen as the result of declining employment and fiscal consolidation. Net exports are projected to detract 0.1 percentage

points from GDP growth as imports increase slightly more than exports. In 2013 and 2014, exports are expected to pick up and outpace a relatively small increase of imports. The contribution of net exports to GDP growth is projected to be 0.7 percentage point in both years. Consumer spending is also projected to return to growth as the labour market stabilises in 2013 and sees a declining unemployment rate in 2014. Overall investment growth is expected to moderate compared to 2012. The PEP stresses that this projection requires (1) an imminent stabilisation of international macroeconomic conditions, (2) a quick implementation and effects of planned structural reforms, and (3) improving economic sentiments.

There are significant downside risks associated with the PEP's growth projection for 2012, not least because some of Croatia's main export markets are in mild recession and because investment by public companies are considered as practically the sole source of growth. Most forecasts from various institutions have turned notably more pessimistic regarding Croatia's growth outlook since last autumn. In December 2011, Croatia's central bank had already projected a small contraction. In February, the IMF projected a decline of about 1% and the average of private bank forecasts was even more negative. The economic data released in the first quarter of 2012 confirm such projections and suggest that Croatia is falling back into recession. After two quarters with mild growth, GDP declined by 0.4% year-on-year in 2011 Q4. In seasonally adjusted quarter-on-quarter terms this can be estimated to correspond to a decline of 1.3%. A renewed downward trend in industrial production has been extended into 2012 with the volume of industrial production being 5.0% lower year-on-year in January-February. Certainly, retail sales were relatively strong in January and February, but they are likely to have been distorted by the announcement of a VAT-increase which came into force at the beginning of March. Employment has trended down in recent months and the rate of registered unemployment increased to 20.1 % in February, 0.5 percentage point higher year-on-year. These data suggest that the economy continues to contract in early 2012. There is no evidence yet of increased investment by public companies and considering the long lead time for investments by public companies in sectors like railways and energy it is doubtful that such investments will be reflected in macroeconomic data for 2012. There are also financing risks related to large-scale investments by public companies as regards credit availability and a relatively high level of interest rates. In the absence of other growth drivers it seems therefore very likely that the GDP forecast for the current year will have to be revised down significantly. To the extent that the recent data softness indicates underlying weakness of competitiveness, the PEP's growth forecast for the following two years may also be too optimistic.

Inflation

Annual average consumer price inflation increased from 1.1% in 2010 to 2.3% in 2011, mainly as a result of higher international prices for energy and food commodities and their pass-through to related domestic prices. The kuna's small depreciation (2.1% in nominal effective terms, annual averages) contributed also to the rise in the price level. Due to the large slack in resource utilisation, not least in the labour market, underlying inflationary pressures were practically absent on the domestic side. This was reflected in a slightly declining price level for services which are less affected by import prices than goods. Croatia's monetary and exchange rate regime continued to provide a stable anchor for the inflation performance.

The PEP expects annual average inflation to remain essentially stable in the programme period, just 0.1–0.2 percentage points above last year's level of 2.3%. This forecast appears plausible and consistent with the projections for growth and employment. It takes into account the various domestic and external forces influencing the price level including the already enacted changes to the VAT rates. The risks to the forecast are appropriately identified. On the downside, it is weaker-than-expected domestic demand, particularly from private consumption. On the upside, it is mainly a new commodity price shock, higher-than-expected increases of administrative prices, and a stronger depreciation of the domestic currency than assumed.

Monetary and exchange rate policy

Like the previous programmes, the current PEP regards exchange rate stability as the precondition for overall macroeconomic stability in Croatia. Monetary policy aims to maintain a stable kuna/euro exchange rate as the main nominal anchor for preserving price stability. The programme's basic assumption is that that the present policy framework of a tightly managed float and price stability as core objective remains in place.

In the recent past, monetary policy has continued to sustain a high level of liquidity in the domestic banking system to encourage lending to the non-financial sector. This goal was, however, subordinated to the need of maintaining exchange rate stability. In the context of some downward pressure against the kuna in the foreign exchange market, the central bank stabilised the kuna-euro rate by selling a total amount of €877.4 million against kuna on five occasions between July 2011 and February 2012. The central bank also withdrew kuna liquidity from the financial system by raising the reserve requirement rate for banks by 1 percentage point in October and again in January, thereby easing the depreciation pressure against the kuna further. The PEP projects that the kuna-euro rate will remain stable throughout the programme period at a level only marginally higher than the 2011 average rate of 7.43 kuna per euro.

External sector

The current account deficit had declined sharply to 1.0% of GDP in 2010 in the context of depressed economic activity and it remained at this level in 2011. Like in the preceding year, the trade performance in 2011 clearly demonstrated Croatia's declining international competitiveness. Market share was lost as exports of goods and services increased by 2.2% in volume terms while the export market (defined as the weighted average of trade partners' import volumes) increased by 5.4% according to the Commission's trade database. Imports of goods and services in volume terms increased by 1.0% although domestic demand contracted by 0.6%.

The PEP projects a small current account surplus in 2012 gradually widening to 1.1% of GDP in 2014. This projection is based on a foreign trade profile in which exports are growing faster than imports in 2013-2014. Based on the pattern of trade performance in the recent past, such a scenario appears implausible because imports can be expected to grow stronger than exports if, as projected, the economy returns to growth – an argument that was still the basis for the current account projection in last year's PEP. Foreign direct investment remained at a low level in 2011 although retained earnings by established foreign companies helped to lift the statistical figure for net FDI inflows to

2.2% of GDP. For the programme years it is expected that FDI will remain at a low level averaging 1.4% of GDP. The PEP states clearly and appropriately that "more intense growth in investments will be conditional on the elimination of a range of obstacles that are currently present on the domestic market". Consistent with the current account projection, external debt is forecast to decline from approximately 100% of GDP in 2012 to around 95% of GDP in 2014. The PEP does not provide an overall assessment of the medium-term sustainability of Croatia's external debt. This is particularly regrettable in view of the very high level of external debt and the risk that the current account may deteriorate again in connection with an economic recovery.

Financial sector

The PEP provides information on institutional developments in the financial sector under "structural reforms", but it does not provide quantitative and qualitative information on financial intermediation, domestic credit developments and the stability of the financial system. But, as reported in the central bank's most recent publication on financial stability, the financial sector has remained stable over the past year. Bank lending to the private sector increased very slowly and was practically stagnant for the household sector when adjusted for exchange rate changes. The capital adequacy ratio of the banking sector stood at a relatively high level of 19.4% at the end of September 2011. However, the ratio of non-performing loans to total loans continued its upward trend albeit at a slower rate than in the preceding two years. It registered 12.4% at the end of 2011 compared to 11.2% at the end of 2010. The deterioration in the quality of bank loans is most pronounced for corporate loans.

Main risks to the macroeconomic scenario

The macroeconomic scenario is considerably more optimistic regarding GDP growth than the current consensus which expects a contraction in 2012. The downside risks to the PEP's growth projection are accentuated by the recent deterioration in the outlook for major export markets, the current oil price level, and the uncertainties surrounding large-scale investments by public companies. Regarding the current account, the main risk is that the deficit recorded in 2011 will widen substantially if growth should develop as projected in the PEP. Regarding the projection of continued low inflation, the risks seem to be relatively moderate and balanced between upside and downside.

2.5 PUBLIC FINANCE

The consolidation of public finances remains a stated objective of fiscal policy in the PEP 2012-2014. The programme stresses the need to achieve sustainability of public finances by reducing the fiscal deficit and reversing the rising trend of the public debt ratio. For this purpose it underlines the importance of implementing the Fiscal Responsibility Law. This means, among other things, that total expenditures of general government as a share of GDP will have to be reduced by a minimum of 1 percentage point each year until the primary balance has been brought back into balance. This particular fiscal rule applies for the first time for the current fiscal year. In 2011, nominal expenditures were kept at the same level as in the preceding year and the state budget

was executed in such a way that the 5.6% of GDP deficit target for general government was met.[5]

Looking forward, net borrowing by general government is projected to decline gradually. The largest decline should already happen in the current year for which a deficit corresponding to 3.8% of GDP in 2012 is projected. Subsequently, the deficit is expected to narrow more modestly to 3.3% in 2013 and to 2.6% in 2014. The fiscal consolidation is planned to be achieved by reducing total expenditures by 4.2 percentage points of GDP over three years to 37.2% of GDP in 2014. Total revenues as a share of GDP are projected to decline modestly by 1.2 percentage points to 34.6% in 2014. In this scenario, public debt will rise by a total of 4.5 percentage points over three years and reach 49.4% of GDP in 2014.

This fiscal strategy appears reasonably ambitious. There are, however, considerable risks that it will not be achieved. One reason is, as mentioned above, that the economic growth forecast on which, in particular, projected tax revenues depend is optimistic, at least for 2012. Another reason is that most of the budgeted expenditure reduction still needs to be specified and implemented, a process which is likely to meet significant legal, administrative and political hurdles. Furthermore, there is a risk that the financing of the public debt will be more costly than projected.

2.5.1 Budget implementation in 2011

The PEP provides only sparse information on how the underlying patterns of revenues and expenditures have developed in 2011. But it is provisionally estimated that net borrowing by general government increased from 4.9% of GDP in 2010 to 5.6% in 2011. This means that the 2011 fiscal deficit is equal to the planned deficit as presented in last year's programme. Unlike in preceding fiscal years, a budget revision was not needed in the course of 2011 which, of course, was facilitated by the relatively large increase of the budgeted deficit. According to the provisional figures provided in the PEP, both total revenues and total expenditures, expressed in nominal terms, have been realised as planned in the PEP 2011-2013.[6] Concerning the central government alone, the PEP-data indicate that 2011 expenditures remained at the previous year’s level in nominal terms. This means, that the decision issued by the Croatian parliament in August 2010 has been implemented, viz. to keep expenditures in 2011 within the limit of expenditures in 2010. Overall, the budget execution in 2011 has been improved compared to previous years.

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[5] According to a more recent provisional estimate from the Ministry of Finance, the fiscal deficit of general government corresponded to 5.0% of GDP in 2011.

[6] Expressed as a share of GDP, revenues and expenditures are both 0.5 percentage points lower than originally planned. But this arises only from a changed 2011-level for nominal GDP which has been put 1.2% higher in this year’s PEP compared to last year’s PEP.

Composition of the budgetary adjustment (% of GDP)						
	2010	**2011**	**2012**	**2013**	**2014**	**Change: 2011-14**
Revenues	37.0	35.8	35.7	35.1	34.6	-1.2
- Taxes and social security contributions	33.1	31.8	31.8	31.0	30.5	-1.3
- Other (residual)	3.9	4.0	3.9	4.1	4.1	0.1
Expenditure	41.9	41.4	39.5	38.4	37.2	-4.2
- Primary expenditure	39.9	39.2	37.2	36.4	35.4	-3.8
of which:						
Gross fixed capital formation	1.3	1.9	1.6	1.6	1.5	-0.4
Consumption						
Transfers & subsidies	23.2	22.0	21.0	20.4	19.6	-2.4
Other (residual)	15.4	15.3	14.6	14.4	14.3	-1.0
- Interest payments	2.0	2.2	2.3	2.0	1.8	-0.4
Budget balance	-4.9	-5.6	-3.8	-3.3	-2.6	3.0
- Cyclically adjusted	-4.5	-5.5	-3.7	-3.2	-2.6	2.9
Primary balance	-2.9	-3.4	-1.5	-1.3	-0.8	2.6
Gross debt level	41.3	44.9	47.2	48.9	49.4	4.5

Sources: Pre-Accession Economic Programme (PEP) 2012, Consumption is part of 'other (residual).

2.5.2 *Near-term and medium-term budget strategy*

Croatia's state budget for 2012, including the budget projections for the two following years, was adopted on 24 February 2012. It provides the main elements for the fiscal scenario in the PEP 2012-2014. The budgetary figures in the PEP are, however, adjusted to comply with the requirement to present budget performance and strategy in terms of general government. For 2012, the authorities envisage the fiscal deficit of general government to decline to 3.8% of GDP from 5.6% in 2011. Total revenues are projected to increase 1.8% although their share of GDP would decline by 0.1 percentage point to 35.7% as nominal GDP is projected to increase by 2.0%. Total expenditures are projected to decrease 2.6% and their share of GDP would decline by 1.9 percentage points to 39.5%. Based on these figures, the fiscal rule in the Fiscal Responsibility Law would be met in 2012 since it requires that total expenditures as a share of GDP are reduced by a minimum of 1 percentage point.

The revenue projection has taken into account the significant changes in the tax legislation which were enacted in February 2012. The general VAT rate has been increased by 2 percentage points to 25% and a reduced rate of 10% has been introduced on a selected range of products and services as of 1 March. The overall VAT reform is estimated to increase revenues by 0.9% on annual basis. A reduction in employers' contribution to the compulsory health insurance from 15% to 13% as of 1 May 2012 is estimated to lower revenues by 0.7% of GDP on an annual basis. Various changes to the income tax regime are expected to be broadly revenue-neutral. Modifications in the profit tax regime are estimated to increase revenues by close to 0.1% of GDP on an annual basis. A relatively costly tax relief for reinvested profits will first be introduced in 2013. Overall, the realisation of the budgeted revenue growth in 2012 depends primarily on whether the projected GDP growth will materialise. If, contrary to the projection, annual

GDP would contract, revenues will undershoot their target in the absence of correcting measures.

On the expenditure side, social transfers are projected to be cut by 2.0% in 2012. Since pension payments will rise as a result of the decision to re-activate their adjustment to inflation and gross salaries, spending on the other components of social transfers (particularly health care) will have to be reduced sharply. The realisation of such cuts already in the current fiscal year will be challenging and depends critically on the swift adoption of appropriate cost saving measures. Likewise, it remains to be seen whether the programmed 4.8% reduction of the public wage bill can be achieved by reducing expenditures relating to special salary supplements, part-time work, overtime work, and special working conditions. Subsidies to agriculture and the railways are projected to be cut substantially which is likely to face legal and political challenges. The budgeted interest expenditure on the public debt may have been underestimated as it implies a declining average interest rate on this debt. Therefore, meeting the expenditure targets in 2012 will be very difficult and require substantial fiscal discipline considering the "stickiness" of much public spending.

Overall, fiscal revenues seem to have been projected in line with recent policy measures and the underlying macroeconomic scenario. On the expenditure side, the budget projects considerable restraint and it may prove challenging to keep expenditures within the budgetary limits. The balance of risks is clearly tilted towards a significantly higher deficit not least because recent economic data suggest that the underlying growth forecast is too optimistic. As an apparent foreboding of these difficulties, the government has announced that there will be a budget revision in the summer, following an assessment of budget performance in the first half of the year.

Beyond the current year, total revenues are projected to rise 1.9% in 2013 and 3.4% in 2014 in nominal terms. This reflects the expected rise in nominal GDP (3.7% and 4.9%, respectively, for the two years), changes in revenues related to EU accession in mid-2013, and the aforementioned changes in the tax regime adopted in February 2012. As a share of GDP, total revenues decline by 1.2 percentage points over three years. On the expenditure side, restraint is projected to continue beyond the current year with total expenditures, in nominal terms, increasing by 1.1% in 2013 and by 1.6% in 2014. On the basis of projected nominal GDP growth, their share of GDP would fall by 1.1 percentage points in 2013 and by 1.2 percentage points in 2014. This means that the fiscal scenario fulfils the requirement set by the Fiscal Responsibility Law that expenditures are to be reduced by a minimum of 1 percentage point of GDP until the primary balance has been brought back to zero or better. A balanced primary budget lies beyond the programme period, as the primary budget is projected to show a deficit of still 0.8% of GDP by 2014. If revenues and expenditures develop as projected, net borrowing by general government would fall to 3.3% in 2013 and to 2.6% in 2014, i.e. a significant fiscal consolidation would be achieved. Like for 2012, these deficit projections are subject to the above-mentioned risks concerning the macroeconomic scenario and the implementation of the underlying expenditure consolidation measures, which are not identified and explained in the PEP. The Croatian authorities, nevertheless, acknowledge such risks and a sensitivity analysis (see section 2.5.3. below) assesses the negative budgetary consequences in scenarios where fiscal policy remains unchanged and where output growth falls short of baseline macroeconomic assumptions.

Structural balance

The PEP 2012-2014 provides estimates regarding the cyclical state of the economy and the fiscal balances, applying the same methodology as in last year's submission. Like in previous years, potential GDP growth has been lowered for the first two programme years and the two preceding years. The method underlying this recalculation is not revealed. For the third programme year (2014) potential growth is estimated at 2.1%. Average projected real GDP growth exceeds average projected potential GDP growth in the programme period. This results in a closing of the negative output gap in 2014. Somewhat counter-intuitively, the negative output gap is estimated to have been as small as 0.3% of GDP in 2011 when the unemployment rate was 13.3%. In the same year, the cyclically-adjusted fiscal balance is seen to have been identical to the unadjusted fiscal balance. The cyclical budgetary component remains very small in the programme period. The structural fiscal balance is considered as being identical to the cyclically-adjusted fiscal balance in 2010-2014. The PEP estimates that fiscal policy has been anti-cyclical in 2008-2011 and will turn slightly pro-cyclical in 2012-2013 before resuming an anti-cyclical stance in 2014. Given the uncertainties relating to the applied methodology, the estimates of potential growth, output gap and cyclically-adjusted fiscal balances should be considered with caution. There is scope for developing the analysis and making it verifiable in future submissions.

Debt levels and development, analysis of below-the-line operations and stock-flow adjustments

The fiscal scenario in the PEP 2012-2014 projects a gradual increase of public debt from an estimated 44.9% of GDP at the end of 2011 to 49.4% at the end of 2014. 7 Projections on the decomposition of changes in the debt ratio show that its rise is exclusively driven by the negative primary balance and interest payments in each programme year. Stock-flow adjustments are projected to lower the increase of the debt ratio to a considerable extent. In 2012, the PEP projects these adjustments to lower the debt ratio by 1.5 percentage points. Privatisation proceeds are contributing 0.6 percentage points while the rest is unspecified. The unspecified part of the stock-flow adjustment rises to 1.9 percentage points in 2014.

[7] The PEP defines public debt according to the Croatian budget act as general government debt, thus excluding guarantees provided by the government to the State Development Bank (HBOR).

Composition of changes in the debt ratio (% of GDP)	2010	2011	2012	2013	2014
Gross debt ratio [1]	**41.2**	**44.9**	**47.2**	**48.9**	**49.4**
Change in the ratio	6.1	3.6	2.3	1.7	0.5
Contributions [2]:					
1. Primary balance	**2.9**	**3.4**	**1.5**	**1.3**	**0.8**
2. "Snow-ball" effect	**2.0**	**1.1**	**1.4**	**0.3**	**-0.4**
Of which:					
Interest expenditure	2.0	2.2	2.3	2.0	1.8
Growth effect	-0.7	-0.5	-1.3	-1.3	-2.2
Inflation effect	0.8	-0.5	0.4	-0.4	-0.1
3. Stock-flow	**1.2**	**-0.9**	**-0.6**	**0.1**	**0.2**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual.

Source: Pre-Accession Economic Programme(PEP); ECFIN calculations

The PEP contains a debt sensitivity analysis which reveals that the public debt ratio is highly sensitive to a depreciation of the kuna-euro exchange rate since most of the outstanding public debt is denominated in foreign currency, mostly in euro. A 25% depreciation of the kuna would lead to an increase in public debt by about 8 percentage points to around 57% of GDP in 2013-2014. The debt level is also highly sensitive to the course of fiscal policy. If fiscal policy would remain unchanged, it is estimated that the public debt ratio would be 8 percentage points higher by 2014 than in the baseline scenario. The activation of contingent liabilities under the restructuring programme for the shipbuilding industry is a third way in which the debt ratio could increase faster than projected. The PEP estimates that it would lift the debt ratio by more than 2 percentage points in 2013.

In terms of debt sustainability a rise of about 15 percentage points in the debt ratio between 2008 and 2011 calls for increased vigilance. In addition, both the sensitivity analysis and the discussion of fiscal risks underline the need for a prudent fiscal policy. A deterioration of financing conditions is a significant risk for the public sector's financing and re-financing requirements in the programme period.

Budgetary implications of major structural reforms

The programme presents estimates of the fiscal impact of structural measures in various policy fields envisaged over the PEP horizon. A summary table is presented below. It shows that the overall net impact on the country's fiscal position is an improvement of around 0.3% of GDP in 2012 and falling to around 0.1% in 2013 and 2014. Most of the specific measures presented in the policy matrix of structural reform measures have a small effect on the budget. The structural reform measure which achieves the largest budgetary saving is a cut in agricultural subsidies in 2012 with an impact corresponding to 0.2% of GDP. Overall, the reform measures presented in the policy matrix are relatively small but positive with respect to the objective of fiscal consolidation.

Net direct budgetary impact of key reform commitments (in million EUR)			
	2012	**2013**	**2014**
Enterprise restructuring and subsidies	11.7	-0.1	-0.3
Labour market reforms	-7.5	21.9	17.4
Agriculture and rural sector	97.0	-8.3	4.2
Health care reforms	3.6	-5.9	4.2
Other reforms	50.7	59.4	10.0
Total impact on the budget	155.5	66.9	35
Total impact on the budget (in % of GDP)	0.33	0.14	0.07

Source: 2012 Pre-accession Economic Programme (PEP), own calculations, a minus sign indicates a deterioration of the budget balance.

2.5.3 Sensitivity analysis and comparison with previous programme

Like in previous years, the PEP 2012-2014 includes a sensitivity analysis which shows how public deficit and debt would react to economic shocks. The debt sensitivity analysis has already been mentioned above. For the fiscal deficit, two alternative scenarios to the baseline are described. The first one assumes an unchanged fiscal policy and fiscal dynamics as recorded in previous years. This would result in fiscal deficits which would be between 2.0 percentage points (in 2012) and 2.7 percentage points (in 2014) higher than in the baseline. It clearly demonstrates the size of the consolidation effort needed which policymakers have to undertake in order to reach their fiscal targets. The second alternative scenario assumes a real GDP growth rate in 2012 which is 1 percentage point lower than in the baseline (i.e. -0.2% rather than 0.8%). This would result in fiscal deficits which would be between 0.4 (in 2012) and 1.1 (in 2014) percentage points higher than in the baseline. Regarding the sensitivity of the fiscal deficit to assumed GDP growth, it would have been appropriate to broaden the analysis to cover a growth rate in 2012 which is equal to the most pessimistic of current growth forecasts (-2%). In addition to the sensitivity analysis, the differences in the fiscal scenarios between the PEP 2011-2013 and the PEP 2012-2014 are shortly summarised. The differences regarding the programme years are attributed to revisions of the underlying macroeconomic projections, the recent changes in tax legislation, and the commitment to cut expenditures through rationalisation of costs and the implementation of structural reforms.

2.5.4 Quality of public finance and institutional features

After referring to last year's budgetary execution without revisions during the year, the PEP 2012-2014 describes a number of measures and developments in 2011 which should improve the quality of public finances. They include changes in the government-sponsored financing models for private business, the rationalisation of the operations of public enterprises, efforts to lower the overall tax burden and non-tax fees, improvements in the management of the public debt, increased efficiency in the use of EU-funds, and the strengthening of administrative capacities. However, the PEP does not address the

need to improve the budgetary process further and to enhance the efficiency of public spending more fundamentally in the programme period. It lacks a vision and a strategy to make use of the considerable scope for rationalising and streamlining public expenditure, in particular to introduce a better targeting of social spending, which could free resources for higher public investment. Low employment and participation rates suggest the need to consider the relevant incentives in the tax system and the benefits regime. Overall, the PEP would benefit from presenting a more convincing policy strategy to improve the quality of public finances through concrete revenue and expenditure measures.

On the institutional side, the PEP describes the follow-up to the adoption of the Fiscal Responsibility Law in 2010, i.e. the adoption of implementing rules and the establishment of a Fiscal Policy Committee charged with the monitoring of the application of the new fiscal rules. It is also mentioned that the government did not last year adopt an annual Strategy of Government Programmes covering the period 2012-2014 contrary to the provisions of the Budget Act. This is explained with the postponement of the normal budgetary process until after the parliamentary elections held in December 2011 and the ensuing change of government. Such a postponement shortens the time available for the preparation of the budget and its parliamentary scrutiny. Thereby, it risks weakening the continuity and quality of the budgetary process. This may be exemplified by the government's announcement at the time of the budget's adoption that a budget revision is likely to be needed already in the summer.

2.5.5 Sustainability of public finance

The PEP 2012-2014 contains a short analysis of the sustainability of public finances in the period up to 2050 with a focus on pension, health and interest expenditure. The assumptions regarding long-term population trends have not been changed compared to last year's PEP, but the labour market participation rates have been revised down. Growth projections for labour productivity and real GDP have been left unchanged for the long term. Total expenditures are projected to decrease from 41.9% of GDP in 2010 to 39.2% in 2020, but then to increase gradually to 42.3% in 2050. Total revenues are set to fall from 37.0% of GDP in 2010 to 35.6% in 2020 where they are projected to remain over the following thirty years. Spending on old-age pensions is expected to remain between 8 and 9% of GDP until 2050 because the growth in the number of pensioners as a share of the total population will be counterbalanced by a rising share of pensions financed from individual capitalised pension funds. Pension contributions would fall initially but then stabilise around 5.2% of GDP in the medium to long term. Health care spending is set to increase markedly in the long term, i.e. from 5.8% of GDP in 2020 to 9.2% in 2050, mainly as a result of an ageing population. Interest expenditure on public debt is projected to rise gradually from 2.0% of GDP in 2010 to 3.4% in 2050.

The long-term fiscal challenges of an ageing society remain significant not least in view of an already relatively high public debt ratio and very low labour market participation rates. However, the programme does not relate its long-term fiscal projections to the need to adopt concrete reform measures in areas like pensions, health care or labour markets which are the areas where reform has the potentially largest budgetary benefits. Overall, the programme would have benefited from sketching the outlines of a policy response to the challenges of an ageing society.

2.6 STRUCTURAL REFORMS

2.6.1 Obstacles to growth and the structural reform agenda

The PEP covers a broad range of structural reform areas identical to last years' programme. It states in a general way that the government will alleviate or eliminate obstacles to growth in various areas with a particular emphasis on the labour market, the business environment and public administration reform. Some of the intended reforms which are mentioned in a general way, like more labour market flexibility and higher efficacy of the judiciary, suggest indirectly where bottlenecks to growth can be found. But there is no attempt to identify these obstacles directly and to assess them systematically, as requested by the Commission.

The programme does not fully and consistently establish a clear link between strategic objectives and the various instruments and measures described. It is mainly backward-looking. To serve as a guide for the implementation of structural reforms, the programme would need to have a sound diagnosis, clear policy targets, concrete measures and a time frame for implementation. More emphasis should also have been given to measures to improve the business environment, given the administrative obstacles still in place. The programme contains fiscal estimates for some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy is weak. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would support the fulfilment of the second Copenhagen economic criteria.

2.6.2 Key areas of structural reform

Product and capital markets

The PEP 2012-2014 touches upon a number of reform areas related to the functioning of product markets, such as competition policy, state aid, privatisation, railway and shipyard restructuring, energy and SME development. In the field of competition policy, the follow-up to the entering into force of the new Competition Act in 2010 is described, particularly the work on establishing a competition assessment procedure for all new legislation and regulation. Regarding state aid, which increased to 2.8% of GDP in 2010, the programme provides only a rough indication of its composition. The structure of state aids is still heavily biased in favour of sectoral aids and their reduction is considered to be dependent on structural reforms in shipbuilding and railways and on the transition to the use of EU funds in agriculture and fisheries. In the field of privatisation the activities of the new Government Asset Management Agency (GAMA) are described in a mainly backward-looking fashion. The process of privatisation of state assets continues to make only slow progress with modest proceeds. In mid-January 2012, GAMA's portfolio comprised 682 companies and had a value of €5.4 billion. A clear time frame for selling or liquidating state assets is still missing (except for the shipyards). Regarding railway restructuring the PEP mentions a number of current efforts, but there is no indication of a clear and comprehensive strategy. Regarding the energy sector, the PEP mainly describes recent and on-going measures in the various areas (natural gas, electricity, transport, renewable energy, energy efficiency, and oil and petroleum products) in accordance with the government's energy strategy. The PEP fails to address the persisting shortcomings in

the overall business environment in the product markets, including weaknesses in the regulatory framework and inefficiencies in public administration.

Labour market

In addition to the severe repercussions of the on-going macroeconomic weakness on employment levels and the number of unemployed, the Croatian labour market suffers from deep-rooted structural problems, as evidenced by very low participation and employment rates as well as high rates of youth and long-term unemployment. The policy response, as described in the programme, does not include strategically relevant reform concepts. It continues to focus on active labour market measures by the Croatian Employment Service. However, as already mentioned in previous PEP assessments, a more comprehensive reform approach seems to be required to address the structural weaknesses of the Croatian labour market. Despite some actions taken, such as reducing incentives for early retirement, labour supply disincentives appear to continue. In line with EU requirements and the Europe 2020 Strategy, labour market policies should pay sufficient attention to tackle skill mismatches and to develop strategies for life-long learning. Labour market policies should be subject to regular results-oriented monitoring and regular independent evaluations.

Other reform areas

Other reform areas covered are the agricultural sector, public administration, education, health care, social security, the judiciary and environmental protection. Like for the previously mentioned sectors, the presentation is mainly backward looking, providing information on past and on-going reform measures and initiatives with a strong emphasis on legislative action. Harmonisation with EU requirements has been treated with priority. The programme would have benefited from discussing the relevance of envisaged reforms in the context of the overall reform strategy.

2.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The programme presents a clear and concise picture of past economic developments and covers most relevant data in an accurate way. Weaknesses remain with respect to data on sector's savings-investment balances. The PEP presents a sufficiently comprehensive and broadly consistent medium-term macroeconomic framework, but it fails to comply with the Commission's request to present an in-depth analysis of external sustainability and competiveness issues.

Fiscal framework

The fiscal programme is broadly consistent with the macroeconomic framework. The programme could have been improved by providing more concrete information on the envisaged fiscal policy measures, in particular on those to rein in current spending. The programme makes an effort to present fiscal data according to ESA standards. Historical data are fully in line with data submitted in the context of the 2011 fiscal notification. Unresolved issues remain with respect to the coverage of the general government sector as a number of "quasi-fiscal activities" (such as the Croatian Bank for Reconstruction and Development (HBOR), and Croatian Motorways) and a large number of municipalities

are not included in the fiscal programme. PEP submissions would benefit from an explanation of operations and future plans of HBOR and Croatian Motorways.

Structural reforms

This part of the programme would gain from presenting an analysis of the structural bottlenecks of growth, as requested by the Commission. A more coherent and consistent presentation of the structural reform agenda, better linking individual reform measures to the programme's key economic objectives and the fiscal strategy, would improve the quality of the programme and its usefulness as a tool for economic policy making.

Annex: Structural indicators

	Croatia					EU 27				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
General economic background										
Real GDP [1]	5.1	2.2	-6.0	-1.2	0.6f	3.2	0.3	-4.3	2.0	1.6f
Labour productivity [2]	75.7	78.6	78.4	77.4	n.a.	100	100	100	100	100
Real unit labour cost [3]	0.0	1.7	3.3	-4.2	-5.1	-0.8	1.0	2.8	-1.6	-0.5f
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	121.4	123.2	118.3	109.0	113.1
Inflation rate [5]	2.7	5.8	2.2	1.1	2.2	2.3	3.7	1.0	2.1	3.1e
Unemployment rate [6]	9.0	8.4	9.1	11.8	13.2	7.2	7.1	9.0	9.7	9.6
Employment										
Employment rate [7]	57.1	57.8	56.6	54.0	n.a.	65.3	65.8	64.5	64.1	n.a.
Employment rate - females [8]	50.0	50.7	51.0	48.8	n.a.	58.2	58.9	58.4	58.2	n.a.
Employment rate of older workers [9]	35.8	36.7	38.5	37.6	n.a.	44.6	45.6	46.0	46.3	n.a.
Long term unemployment [10]	5.7	5.3	5.1	6.7	n.a.	3.1	2.6	3.0	3.9	n.a.
Product market reforms										
Relative price levels [11]	71.9	74.1	75.5	75.9	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	26.4	24.4	25.0	26.3	n.a.	10.7	11.6	9.8	11.7	n.a.
Net FDI [13]	4.4	3.6	3.4	0.7	n.a.	3.9	2.2	2.1	1.0	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.6	0.6	0.6	n.a.
Business investment [16]	n.a.	n.a.	n.a.	n.a.	n.a.	18.7	18.4	16.2	15.9	n.a.
Knowledge based economy										
Tertiary graduates [17]	6.8	10.1	12.8	n.a.	n.a.	13.8	14.5	14.3	n.a.	n.a.
Spending on human resources [18]	4.1	4.3	n.a.	n.a.	n.a.	5.0	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	95.3	95.4	95.2	95.7	n.a.	78.1	78.5	78.6	79.0	n.a.
R&D expenditure [20]	0.8	0.9	0.8	0.7	n.a.	1.9	1.9	2.0	2.0	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	25.7	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Number of broadband access lines per 100 inhabitants.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources

3 ICELAND

3.1 EXECUTIVE SUMMARY

Iceland's Pre-Accession Economic Programme 2012-2014 (PEP) was submitted on 1 February 2012. Its main objective is to lay the foundations for a sustainable economic recovery after a long and deep recession. It presents a broadly plausible medium-term macroeconomic scenario and a relatively ambitious fiscal scenario, although both subject to considerable downside risks. The quality of the programme could be significantly enhanced by adding alternative growth scenarios and a budget sensitivity analysis to better identify and quantify the impact of potential risks. There is also scope for improving the fulfilment of formal and data requirements.

Since the end of 2010, the economy has started to mildly recover and real GDP grew by a stronger than expected 3.1% in 2011. The situation on the labour market started to improve in mid-2011, although job creation and long-term unemployment remain a serious challenge. Strong domestic demand has pushed inflation up and, despite robust export performance, led to a reduction of the surplus in trade in goods and services. The central bank reacted to a growing inflationary pressure by increasing its key policy rate but the monetary stance remained rather accommodative. Official gross foreign currency reserves continued to increase, reaching 64% of GDP by the end of 2011. Financial sector balances and intermediation remain impaired. Achievements in macroeconomic stabilisation have been made under the shelter of extensive capital controls which, after having been in place for more than 3 years, risk becoming entrenched if more resolute measures for their lifting are not taken.

The PEP 2012-2014 presents a broadly plausible growth scenario with a modest recovery, driven by private consumption, investments, and exports. Government consumption is set to further decline and to start increasing only in the outer years of the programme. Total investments remain at a historical low of about 14% of GDP but are expected to gain speed as the economy recovers and big energy-intensive projects come out of the pipeline. Domestic demand is projected to drive imports growth, exceeding the growth of exports over the programme horizon. As a result, the external trade surplus is set to fall to below 8% of GDP in 2014. The inflation outlook is based on the central bank's November 2011 forecast and does not take into account a recent acceleration in inflation and inflation expectations. The current account, adjusted for the net factor income of banks in winding-up proceedings, posted a small deficit in 2011 but is expected to turn into a surplus and stay positive over the programme horizon. The programme lacks a detailed assessment of the structure and financing of the current account. It does not provide any analysis of its sustainability over the medium term, including competitiveness issues, as was requested by the Commission for the 2012 programmes.

Fiscal consolidation has been a success over the recent years. The primary deficit was reduced to around 1% of GDP in 2011 and the increase in the debt-to-GDP ratio was brought to a halt. However, consolidation efforts slowed down in 2011 and slippages led to a higher than expected budget deficit. In addition, the revision in October 2011 of the medium-term budgetary scenario envisaged a milder medium-term adjustment. Some ambiguity remains with respect to the composition of the planned fiscal adjustment.

While the consolidation seems to be expenditure-led, as the spending to GDP ratio is planned to fall markedly, this adjustment pattern is not sufficiently reflected by the choice of underlying fiscal measures, which are mostly on the revenue side. Moreover, the proposed consolidation path counts very much on temporary non-tax revenues and some measures remain unspecified or have not been legislated. In view of risks of further fiscal slippages and the already high level of government debt, it will be of utmost importance that the government follows on its ambitious target of bringing the debt level below 60% of GDP by 2020. The credibility of the fiscal programme could have been strengthened by providing more details about the 2011 budget execution and a more elaborated assessment of policies supporting the medium-term budgetary framework, the risks involved, and possible contingency measures to address these risks.

The PEP covers a broad range of structural reform areas with a view to improving the supply side of the economy and increasing its resilience. However, the level of detail in presenting key policy measures is insufficient and could be improved. The programme would also benefit from providing a clear timeline and sequencing of planned measures, along with information about their estimated budgetary impact. In the short term, the still precarious situation of the financial sector and the high household and corporate indebtedness are identified as major obstacles to a sustainable recovery. This is coupled with the problem of inefficient capital markets and existing restrictions on capital movement. As a medium to long-term challenge, the programme outlines the need for export diversification to alleviate overreliance on certain commodity exports.

Risks to the programme scenario are mostly on the downside. Private consumption has proven surprisingly strong in 2011 on the back of higher wages and social benefits, and other temporary factors, the importance of which is likely to diminish over the medium-term. There are also risks to the envisaged investments profile, related to the on-going corporate debt restructuring and possible delays in energy-intensive projects. Extensive capital controls are one of the most salient features of the economy and their removal represents a particular challenge. A weak and slow recovery of Iceland's major overseas markets could also undermine even the modest exports performance. After budgetary slippages last year, and with parliamentary elections in 2013, the consolidation path may weaken further, especially in view of the uncertainty surrounding some of the consolidation measures and the composition of adjustment.

The link between the programme's reform agenda and the fiscal scenario is not sufficiently clear. In view of the country's EU accession perspective, as spelled out in the latest Progress Report, Iceland has taken some steps in aligning its reform priorities to the *acquis.*

Comparison of macroeconomic developments and forecasts

	2010		2011		2012		2013		2014	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	-4.0	**-4.0**	2.1	**2.6**	1.5	**2.4**	2.7	**2.5**	n.a.	**2.8**
Contributions:										
- Final domestic demand	-2.2	**-2.0**	2.7	**2.3**	1.9	**3.3**	2.9	**2.5**	n.a.	**3.0**
- Change in inventories	n.a.	**-1.0**	n.a.	**0.5**	0.0	**-0.3**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-1.5	**-1.1**	-0.6	**-0.1**	-0.4	**-0.5**	-0.2	**0.0**	n.a.	**-0.2**
Employment (% change) [1]	-0.3	**-1.2**	0.2	**1.8**	0.2	**1.9**	0.5	**1.3**	n.a.	**0.9**
Unemployment rate (%)	8.0	**8.4**	7.6	**7.6**	7.3	**6.4**	6.7	**5.8**	n.a.	**5.4**
GDP deflator (% change)	6.9	**6.9**	3.7	**4.0**	3.4	**5.0**	3.1	**2.7**	n.a.	**2.8**
CPI inflation (%)	5.4	**5.4**	4.1	**4.0**	3.6	**4.2**	2.8	**2.9**	n.a.	**2.5**
Current account balance (% of GDP)	-11.2	**-11.2**	-10.4	**-9.3**	-9.6	**-4.1**	-9.5	**-1.7**	n.a.	**-2.4**

Sources: Pre-Accession Economic Programme (PEP) 2012; Commission 2011 Autumn Forecasts (COM)

1. Employment deffinitions differ and data are incomparable.

3.2 INTRODUCTION

On 1 February 2012, Iceland submitted its second Pre-Accession Economic Programme, following government adoption and earlier consultation of social partners. The programme was prepared by the Ministry of Economic Affairs with the participation of the relevant ministries and agencies and covers the period 2012-2014. It builds on earlier policy documents, such as the government's 2020-strategy adopted in January 2011,8 the revised medium-term fiscal objectives from October 20119 and the government's economic programme of November 2011.10 The key policy objective of the programme is to secure a sustainable economic recovery, based on the pursuit of fiscal consolidation and on measures strengthening the supply side of the economy. To this end, a number of key priorities, such as maintaining fiscal coherence, continuing efforts to complete private sector debt restructuring, redesigning the monetary policy framework, and tackling long-term unemployment are seen as the cornerstones of the programme.

3.3 KEY CHALLENGES

Economic policy challenges in Iceland remain manifold. A core objective of the programme is to lay strong foundations for sustainable economic recovery and, in parallel, continue tackling the remnants of the longest and most severe recession since Iceland's independence. Extensive capital controls are one of the most salient features of the economy. Their removal will be a key challenge for the government. Free capital movement is a prerequisite for sustainable growth based on domestic and foreign investments and needs to be implemented in a careful manner, in close coordination with other policies, to preserve price, exchange rate and financial stability. To this end, the government and the central bank continued to implement the first phase of their March 2011 capital account liberalisation strategy,11 although with mixed success until now.

[8] http://eng.forsaetisraduneyti.is/media/2020/iceland2020.pdf

[9] http://www.fjarmalaraduneyti.is/media/utgafa/Rikisbuskapurinn_2012_2015.pdf (in Icelandic)

[10] http://eng.efnahagsraduneyti.is/media/Acrobat/ECONOMIC-PROGRAMME-ENGLISH112011.pdf

[11] http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8673

There have been further advances in macroeconomic stabilisation but the PEP acknowledges policy challenges ahead. Striking the right balance between the still needed efforts to reign in budget deficit and government debt and supporting the economic recovery is one of them. Fiscal consolidation continued in 2011 but consolidation efforts have been slowing down. Looking ahead, the envisaged consolidation path has been weakened compared to previous plans, although it still remains relatively ambitious. The composition of the planned adjustment is not sufficiently clear and risks are related to the fact that the strategy very much counts on temporary non-tax measures like asset sales and other unspecified or unlegislated measures. Concerns remain about the high level of public debt and the possibility of meeting the ambitious target of bringing down government debt below 60% of GDP by 2020. Although steps have been taken to tackle the considerable domestic debt overhang, private sector debt restructuring is not yet completed. The banking sector and financial intermediation are still not fully functioning and efficient. The labour market has shown some signs of revival, with the unemployment rate and net emigration falling down. Nevertheless, job creation will remain a challenge for some time, as the economy is still adjusting after the crisis. Wages and inflation have increased more than expected in 2011 and are estimated to remain elevated over 2012.

3.4 RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

3.4.1 Recent macroeconomic developments

Following the collapse of its financial sector in October 2008, the Icelandic economy went into a deep and long recession, contracting by 6.8% in 2009 and by a further 4.0% in 2010. Since the end of 2010 the economy started to recover, based on stronger private consumption, exports and investments (albeit from a very low level). GDP increased by 3.1% in 2011 and the growth rate was higher than the autumn 2011 official forecast of Statistics Iceland of 2.4%. In line with renewed expansion of the economy, the labour market stabilised. The average number of employed persons remained broadly unchanged in 2011 but those working full-time increased along with an increase in working hours. The unemployment rate fell to 7.1% (Labour Force Survey) as a number of unemployed exited the labour force, still a long way from the pre-crisis levels of around 3%. Long-term unemployment started to decline but is still significant at about a quarter of all unemployed. Annual inflation accelerated to reach 6.4% in March 2012 and remained elevated since then. Higher international commodity and energy prices explain only partially the bout of rising inflation. Strong domestic demand has also been an important inflationary driver and domestic goods and services, including housing, contributed to more than half of the overall inflation. The central bank reacted to rising inflation and inflationary expectations by increasing its key policy rate in three steps from 4.25% to 5.00%. Exports were robust in 2011, supported by higher fish and aluminium prices and a growing interest in Iceland as a tourist destination. Nevertheless, the surplus in trade in goods and services fell from 10.1% in 2010 to 8.2% of GDP in 2011, as imports grew faster than exports. The current account deficit stood at 7.1% of GDP in 2011, down from 8.0% in 2010. The "underlying" current account balance as calculated by the central bank (i.e. excluding accrued interest of banks in winding up proceedings) improved from a deficit of 2.0% in 2010 to a deficit of 0.6% of GDP in 2011. Official foreign currency reserves increased by 57% year-on-year to 64% of GDP at end-2011 (2010: 43% of GDP). The stock of gross external debt (excluding banks in

winding-up proceedings) has increased as well to an estimated 220% of GDP, compared to 215% at end-2010.

3.4.2 *Medium-term macroeconomic scenario*

The PEP 2012-2014 presents a broadly plausible growth scenario with a modest recovery, driven by private consumption, investments and exports. The external assumptions are based on the most recent IMF and OECD global forecasts by the time of drafting. On this basis, the PEP expects Iceland's trading partners' GDP to rise by 1.5% in 2012 and 2.1% in 2013, which appear to be somewhat optimistic in light of the most recent estimates of negative growth in the euro area in 2012.

Comparison of macroeconomic developments and forecasts

	2010		2011		2012		2013		2014	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	-4.0	**-4.0**	2.1	**2.6**	1.5	**2.4**	2.7	**2.5**	n.a.	**2.8**
Contributions:										
- Final domestic demand	-2.2	**-2.0**	2.7	**2.3**	1.9	**3.3**	2.9	**2.5**	n.a.	**3.0**
- Change in inventories	n.a.	**-1.0**	n.a.	**0.5**	0.0	**-0.3**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-1.5	**-1.1**	-0.6	**-0.1**	-0.4	**-0.5**	-0.2	**0.0**	n.a.	**-0.2**
Employment (% change) [1]	-0.3	**-1.2**	0.2	**1.8**	0.2	**1.9**	0.5	**1.3**	n.a.	**0.9**
Unemployment rate (%)	8.0	**8.4**	7.6	**7.6**	7.3	**6.4**	6.7	**5.8**	n.a.	**5.4**
GDP deflator (% change)	6.9	**6.9**	3.7	**4.0**	3.4	**5.0**	3.1	**2.7**	n.a.	**2.8**
CPI inflation (%)	5.4	**5.4**	4.1	**4.0**	3.6	**4.2**	2.8	**2.9**	n.a.	**2.5**
Current account balance (% of GDP)	-11.2	**-11.2**	-10.4	**-9.3**	-9.6	**-4.1**	-9.5	**-1.7**	n.a.	**-2.4**

Sources: Pre-Accession Economic Programme (PEP) 2012; Commission 2011 Autumn Forecasts (COM)

1. Employment deffinitions differ and data are incomparable.

Real sector

The PEP projects a continuation of the economic recovery which has gained pace in 2011. Real growth is projected to average 2.7% over the medium-term, boosted by robust private consumption, pick-up of investments (from a very low level) and modest increases in exports. Private consumption is foreseen to grow by about 3% on average over the programme horizon, supported by rising incomes and employment, and is arguably to remain the main driver of growth. In 2011, total investments stood at a historically low level of about 14% of GDP but are set to gain speed and grow by 11% on average, as the economy recovers and big energy-intensive projects come out of the pipeline. Growth in exports is expected at about 2%, while strong domestic demand will be driving imports growth to above 3% on average. As a result, the external trade surplus is set to decrease from 10.1% of GDP in 2010 to below 8% of GDP in 2014.

While broadly realistic, the PEP growth scenario is subject to considerable downside risks. In 2011, private consumption has proven surprisingly strong on the back of higher wages and social benefits, freezing of loan payments and withdrawals from private pension accounts. The importance of these factors is likely to diminish over the medium-term, while elevated inflation could undermine households' real purchasing power in a still fragile labour market. The still high level of private sector indebtedness would continue to exert pressure on households' finances even after the debt restructuring is

completed. The PEP rightly points out that there are risks to the envisaged investments profile. Corporate investments' performance will depend on progress in the on-going restructuring of corporate balance sheets. The recovery of residential investment, although under way, may be impeded by the potentially ample supply of uncompleted residential property. In addition, investments in energy-intensive projects, included in the forecast, are prone to delays. A weak and slow recovery of Iceland's major overseas markets could also undermine even the modest exports performance. The PEP also acknowledges that some export sectors have benefited from a competitive real exchange rate and may start losing price competitiveness as the economy recovers. The programme does not explore in details the impact of capital controls on the economy and does not present any other alternative medium-term scenario. Such an analysis would help focus awareness of accumulating costs of the capital controls for the Icelandic economy.

Inflation

The PEP projects annual inflation to peak at about 6% in the first quarter of 2012, subsiding thereafter to 3% by the end of the year and reaching the inflation target (2.5%) by the end of 2013. However, this inflation outlook is based on the central bank's November 2011 forecast and does not take into account a recent acceleration in inflation and inflation expectations. Inflation risks over the medium-term appear to be on the high side. The most recent forecast from February already envisaged a higher inflation profile and inflation reaching its target only in the second half of 2014. The economic recovery and wage increases in 2011, which resulted from the implementation of collective wage agreements, have led to strongly rising prices, including of domestically produced goods and services, pointing to the existence of structural or policy weaknesses and rigidities in the economy. Inflation expectations have also significantly increased and the risk of entrenching inflation expectations at high levels is recognised by the programme. Furthermore, the inflation outlook very much relies on the assumption of continued exchange rate stabilisation. A stable nominal exchange rate of the króna against the euro is foreseen over the programme horizon, but so far has not materialised as the exchange rate has depreciated markedly since the beginning of 2012. Preserving króna stability in the context of the gradual lifting of capital controls will present a particular challenge.

Contrary to the previous submission, the PEP does not comment on output gap levels or delve into the concept of non-accelerating inflation rate of unemployment but, nevertheless, points out that there is significant uncertainty about the extent to which there is some spare capacity left in the economy and how effective it is in containing inflationary pressures.

Monetary and exchange rate policy

The PEP acknowledges that capital controls have permitted a more rapid lowering of interest rates in the crisis. This trend started reversing in August 2011, in response to rising inflation, and, following three 25 p.p. hikes, the central bank's key interest rate reached 5.00% in March 2012. Nevertheless, the monetary policy stance remained rather accommodative by the end of the year and in the first months of 2012.

In 2010, the central bank elaborated a report on exchange rate and monetary policy after capital controls.12 The report suggested modifications in the current inflation targeting regime with a stronger focus on asset price cycles, more active foreign exchange market interventions, better coordination between monetary and fiscal policy and introduction of macro-prudential rules. Preparations for the actual implementation of these suggestions are still on-going. As mentioned in the PEP, the central bank is now working on a new report examining the benefits and drawbacks of different exchange rate regimes "with focus on the adoption of the euro, through EMU membership". While considerations about defining elements of the long-term monetary and exchange rate policy framework are certainly challenging and necessary, the PEP would have benefited from an analysis of the medium-term prospects of the current monetary and exchange rate strategy.

External sector

The PEP's section on external developments is limited and rather backward looking, recalling the strong adjustment of the balance of goods and services from high pre-crisis deficits to post-crisis surpluses that resulted from the sharp increase in exports and compression of imports, mainly due to a weaker króna.

Exports, including revenues from tourism, further increased in 2011. However, driven by robust domestic demand, imports have expanded at a faster pace than exports, effectively reducing the trade surplus. The good performance of domestic tourism in 2011 has been accompanied by increased travel abroad, and the net contribution of travel services has indeed slightly deteriorated. The deficit in the income balance remained significant, keeping the current account in deficit. A large share of this deficit comes from unpaid accrued interest on banks in winding-up proceedings (about 6.5% of GDP in 2011). Adjusted for the net factor income of these banks, the current account posted a small deficit in 2011 but is expected to turn into a surplus and stay positive over the programme horizon.

Price increases in USD for aluminium are projected to be moderate over the programme horizon, after having risen substantially in the last two years. The price of the other major export commodity (marine products) is expected to increase by about 5% in 2012, following two consecutive years of steady growth. In 2012-2014, domestic demand is expected to drive the growth of imports of goods and services above the growth of exports. As a result, the external trade surplus is set to fall to close to 7% of GDP in 2014. There are certain risks to this profile as the 2011 outcome was worse than expected in the programme. In addition, exports of goods continue to be characterised by capacity constraints in important exporting sectors and lack of diversification. Having in mind the current historically low level of investments, as the economy and investment activity recovers, there would be a need for sustained increase in imports of investment goods that could quickly reduce current levels of trade surpluses.

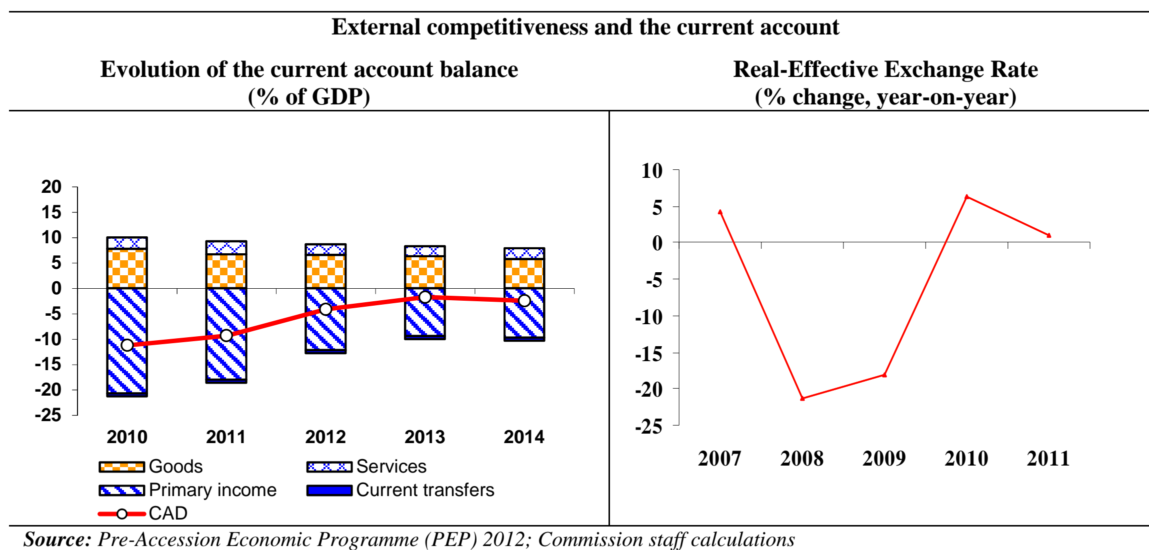
The PEP lacks a detailed assessment of the structure and financing of the current account and its sustainability over the medium term. It could also have been strengthened by providing an analysis of competitiveness issues, notably on developments in price and cost competitiveness and in export market shares in goods and services. Recent increases in exports have benefited heftily from real exchange rate depreciation and high world

[12] http://www.sedlabanki.is/lisalib/getfile.aspx?itemid=8529

prices for marine products and aluminium. The PEP does not make any projection about capital flows and their composition, although at least an analysis of recent dynamics and short-term trends and expectations may have been warranted. It is also notable that net errors and omissions remain exceptionally volatile, obscuring proper analysis of balance of payments flows.

In March 2011, the Government adopted a revised capital liberalisation strategy. It envisages two phases of gradual liberalisation, with a focus on foreign (off-shore) holdings of króna. The first phase is already under way. The central bank holds auctions to purchase off-shore króna which it offers to investors willing to buy government bonds, other domestic assets, or invest in Iceland, locking-in their investment for a certain period. The final step in this phase would be to impose an exit levy and/or issue a long-term government bond in foreign currency. Once the outstanding amount of off-shore króna and the difference between on-shore and off-shore exchange rates have been reduced, the capital controls on domestic economic actors could be liberalised (the second phase). The PEP also spells out a number of additional conditions (changes to the central bank law, building a framework for macro-prudential policies and developing macro-prudential tools), aiming to rebuild confidence in the financial system before the full liberalisation can take place. In September 2011, the parliament extended the capital controls until the end of 2013. In early 2012, capital controls have been further tightened by removing the exemptions on some bond payments and regulating the payments made by the estates of the old banks. Overall, the liberalisation of off-shore holdings of króna has had a mixed success up to now. The outstanding amount of off-shore króna (about 30% of GDP) and the difference between on-shore and off-shore króna/euro exchange rates (about 30-40%) remain significant.

External competitiveness and the current account



Source: *Pre-Accession Economic Programme (PEP) 2012; Commission staff calculations*

With a view to discussing Iceland's external vulnerabilities, the PEP could have briefly assessed the level of foreign reserves on the basis of standard liquidity and solvency indicators and, more generally, Iceland's net international investment position in the context of the capital liberalisation strategy. External assets and liabilities continue to be subject to fluctuations, mainly due to uncertainties about the balance sheets of the banks in winding-up proceedings which account for the bulk of external liabilities. Official data

show gross external debt as high as 834% of GDP. However, corrected for the banks in winding-up proceedings, the level of external debt stood at about 220% of GDP at the end of 2011. The international investment position, again excluding banks in winding-up proceedings, has improved to a deficit of about 50% of GDP. The central bank continued building-up reserves and by the end of 2011 its net foreign assets have reached about 40% of GDP.

Financial sector

The PEP provides a rather comprehensive and balanced assessment of the financial sector's vulnerabilities and resilience, based on the central bank's financial stability assessment. There has been significant progress with the restructuring of the financial sector, although its balance sheets are still impaired and new lending is anaemic. It is encouraging that the banks were able to improve their financial results and strengthen their capital base over 2011. In September 2011, the capital adequacy ratio (24%) of the three biggest banks was well above the regulatory minimum of 16%. The Housing Financing Fund (HFF) capital ratio increased to 2.4% in June, although still below its 5% target. The market continues to be highly concentrated, dominated by three big banks, which have expanded marginally over the last year mainly through mergers and acquisitions of other much smaller financial institutions, as well as the HFF. The government retains majority ownership in one of the banks, and minority stakes in the other two banks; with the majority stakes owned indirectly by the winding-up committees of the old banks. While new bank lending remained stagnant, the HFF lending has been expanding recently. The sector remains vulnerable due to its weak asset quality and the uncertainty surrounding the restructuring and evaluation of loan portfolios. Non-performing loans fell marginally but still stood high at about 16% in September 2011. Banks continued to rely for their funding predominantly on short-term deposits. This presents a potential liquidity management challenge and is forcing them to hold substantial secure liquid assets. The PEP rightly points out that this unfavourable structure is linked to the capital controls. Banks should also be able to strengthen and improve their deposit base structure once these controls are lifted. In view of the high uncertainty and costs that the on-going process of loan restructuring infuses to the financial sector and the whole economy, it is imperative that it is completed as quickly as possible. Going ahead, even after restructuring, households and corporate debt would remain high and would necessitate close monitoring. The PEP does not analyse the links between the financial sector and the medium-term growth scenario, which are of crucial importance for the sustainability of the economic recovery. Future submissions would certainly benefit from their exploration.

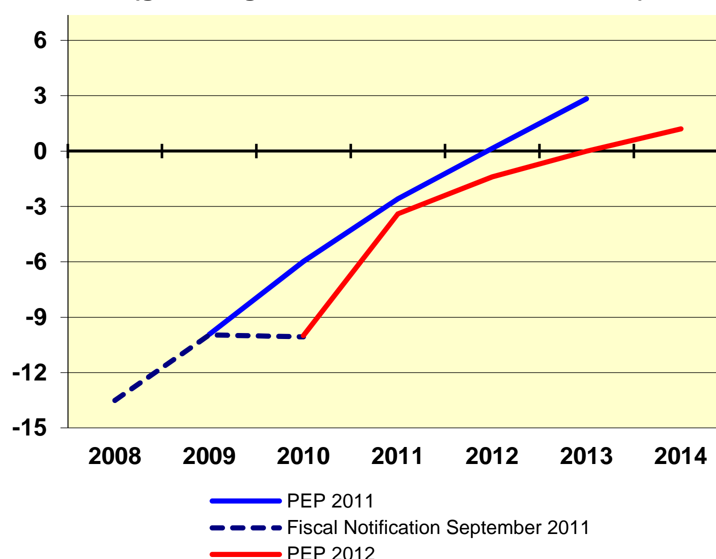
Main risks

Overall, the programme broadly identifies the main risks to the macroeconomic scenario over the medium-term. Maintaining external competitiveness could be challenging, especially if inflation remains elevated and the real effective exchange rate appreciates significantly. Attracting and sustaining higher domestic and foreign investments could also prove difficult, in a still uncertain international economic environment. Economic recovery may also be impeded by unfinished household and corporate debt restructuring and a weak financial sector. Finally, the gradual capital account liberalisation remains a key challenge for the authorities.

3.5 PUBLIC FINANCE

Fiscal consolidation has been a success over the recent years, with significant frontloading of the adjustment. The primary deficit was reduced to around 1% of GDP in 2011 and the increase in the debt-to-GDP ratio appears to have been brought to a halt. However, consolidation efforts have slowed down in 2011 and there were some slippages which have led to a higher than expected budget deficit. In addition, the revision in October 2011 of the medium-term budgetary scenario has envisaged a milder medium-term adjustment. The composition of the planned adjustment is not sufficiently clear as the outlined measures are almost exclusively on the revenue side, while the brunt of the adjustment is still to be borne predominantly on the expenditure side. The proposed consolidation path is also increasingly counting on temporary non-tax measures and other unspecified or unlegislated measures. In view of risks of further fiscal slippages and the already high level of government debt, it will be of utmost importance that the government follows on its ambitious target of bringing it below 60% of GDP by 2020. The programme could have provided more details about the 2011 budget execution and the policies and risks behind the medium-term budgetary framework.

The fiscal programme envisages a continuing improvement of the consolidated general government balance by close to 5 percentage points of GDP, turning from a deficit of 3.4% of GDP in 2011 to a surplus of 1.2 % in 2014. The primary deficit is set to improve as well, from a deficit of 0.6% to a surplus of 4.4% of GDP. The actual 2011 deficit has been recently reported by Statistics Iceland at 4.4% of GDP, a full percentage point higher than PEP's estimates. The underperformance in 2011 weakens substantially the starting point of the planned fiscal consolidation, which is based on a reduction of the total expenditure-to-GDP ratio by 4.3 percentage points over the programme horizon to 41.2% in 2014. The PEP does not provide sufficient information to identify the sources of expenditure reduction, undermining the credibility of the medium-term fiscal programme. Total revenue is set to increase marginally by 0.4 percentage points to 42.4% of GDP in 2014, largely due to unspecified or temporary measures. The general government debt ratio is projected to decline by 13.5 percentage points, from 98.4% of GDP in 2011 to 84.8% of GDP in 2014.



3.5.1 Budget implementation in 2011

The PEP does not present a detailed analysis of the actual budgetary execution in 2011. The central budget deficit is estimated at about 2.8% of GDP, making most of the estimated general government deficit of 3.4% of GDP in 2011. According to Iceland's most recent "Reporting of Government deficits and Debt Levels" (of 15 March 2012), the actual budgetary outcome has been worse than the one reported in the programme, with a deficit for the general government of 4.4% of GDP in ESA95 terms. The slippages were mainly on the expenditure side and at central government level, while local government budgets performed better than expected posting a deficit of 0.3% of GDP.

The initial 2011 budget included a set of ambitious consolidation measures, amounting to around 2.7% of GDP with most of the adjustment on the expenditure side. They included freezes of nominal wages and benefits, cuts in current and capital spending as well as increased taxation of capital income and net wealth, higher inheritance tax and introducing a new bank levy. Overall, revenue execution (on a cash basis) has been broadly satisfactorily, with taxes on income and profits, excises and social security contributions performing relatively well. On the other hand, revenue from value added tax, about a quarter of all treasury revenue, underperformed, despite booming private consumption. Budget performance has been weakened by the government decision to implement the spring collective wage agreements in the public sector, which has absorbed some of the envisaged savings on the expenditure side. Contingent liabilities have not influenced the 2011 deficit but remain a source of risk for the budget over the medium term.

3.5.2 Near-term and medium-term budget strategy

The PEP's fiscal scenario contains a relatively detailed presentation of the operations of the central government but fails to present sufficient information about the general government. Fiscal projections for 2012 are based on the budget adopted in December

2011 and target a general government deficit of 1.4% of GDP (of which 1.2% at central government level). The 2012 budget includes new consolidation measures, most of them on the revenue side, amounting to around 1.7% of GDP (see Box 1). The revenue forecast is rather conservative as the programme does not envisage significant increase in the revenue-to-GDP ratio. On the other hand, the development of the medium-term expenditure profile, which dominates the adjustment, is not sufficiently elaborated in the PEP.

Expenditure restraint measures are projected at ISK 8.1 billion, or around 0.5% of GDP in 2012. They include mainly cuts in current expenditure and transfers (about ISK 4 billion each) and ISK 0.2 billion savings in maintenance and capital expenditure. Over 2013-2015, government ministries and agencies are to save ISK 5 billion per year through additional but unspecified measures. At the same time, central government spending on wages in 2012 and 2013 is set to increase by more than 3% each year, due to the implementation of the wage agreements, and to continue to rise in 2014-2015 by 0.5 percentage points above the forecasted rate of inflation. The implementation of the wage agreements is also leading to increased spending on social security benefits. An unspecified, real increase in expenditure related to the aging population, disability benefits and medicines is also envisaged while spending on unemployment benefits is expected to be lower, in line with the envisaged reduction in unemployment. Most of the current expenditure and transfer payments are set to rise only with inflation but the programme fails to provide sufficient details about the expenditure structure and the envisaged measures that would underpin the foreseen expenditure profile. The public investment to GDP ratio slightly declines over the PEP horizon from already very low levels.

Revenue increasing measures are set to yield ISK 20.7 billion, or 1.2% of GDP in 2012. They include the introduction of a new tax on salary payments of financial institutions, pension funds, and insurance companies, new tax bracket for the tax on wealth, increase of the fishing fee and of the reference price for the carbon tax, reduction of the tax deduction permitted for third-pillar pension savings and extension of the possibility of withdrawing third-pillar pension savings by one more year. All these measures are estimated to generate ISK 11.7 billion in additional revenue, to be topped-up by asset sales and dividends for another ISK 9 billion. Over 2013-2015, the PEP's fiscal scenario envisages that revenue measures would bring on average 1.7% of GDP per year additional revenue. Most of this revenue, though, depends on measures that are uncertain (dividends and asset sales), have not been enacted or specified.

General government total revenues are projected to increase slightly by 0.1 percentage point of GDP, from 42.0% in 2011 to 42.1% in 2012. Total expenditure as a share of GDP are set to continue falling, from 45.4% in 2011 to 43.6% in 2012. The primary balance is expected to turn from a deficit into a surplus of 1.9% of GDP for the first time since the crisis and to continue to improve by 1.3 and 1.1 percentage points of GDP in 2013 and 2014.

Fiscal measures in the 2012 budget

Revenue measures*		Expenditure measures**	
Assets sale	(ISK 7.0 bn)	Cuts in current spending	(ISK 4.0 bn)
Dividends	(ISK 2.0 bn)	Cuts in transfers	(ISK 3.9 bn)
Wealth tax	(ISK 1.5 bn)	Cuts in maintenance and capital expenditure	(ISK 0.2 bn)
Fishing fee	(ISK 1.5 bn)		
Carbon tax	(ISK 0.8 bn)		
Tax on financial institutions salaries	(ISK 4.5 bn)		
PIT on pension withdrawal	(ISK 1.4 bn)		
Third-pillar pension savings	(ISK 2.0 bn)		
Total effect on revenue: ISK 20.7 billion (1.2% of GDP)		**Total effect on spending: ISK 8.1 billion (0.5% of GDP)**	

* Estimated impact on central government revenues. The initial proposal for a 10.5% tax on financial institutions salaries has been modified to 5.45% tax on wages plus additional 6% tax on profits to be levied over a certain threshold.
** Estimated impact on central government expenditure.
Sources: PEP 2012

Fiscal adjustment has been weakened compared to previous plans, although it still remains relatively ambitious. It relies on temporary and unspecified measures, especially in the outer years of the programme. Revenue estimates are rather conservative, in line with the expected recovery of the economy and matching the uncertainty surrounding some of the consolidation measures on the revenue side. As regards expenditure, the PEP points out that the room for further savings has narrowed considerably. Nevertheless, the medium-term consolidation depends mainly on the expenditure side, as the programme envisages only modest increases in spending, in general, below inflation rates. The credibility of the programme suffers from the lack of sufficient details about the sources of this expenditure profile.

Risks

The fiscal scenario is built on broadly realistic growth assumptions but it, nevertheless, faces several risks. The first is related to the actual 2011 budgetary outcome, which proved to be worse than expected, making the starting point for the medium-term adjustment weaker. Another source of tension comes from the need to balance fiscal consolidation efforts with the support of the economic recovery. It is coupled with an obvious 'consolidation fatigue' after several years of significant efforts, which have strained the society and the economy. The PEP acknowledges the importance of these factors and envisages a milder, although still relatively ambitious, adjustment path. Manifold risks, even for this weaker fiscal scenario, stem from the unfinished agenda of restructuring the financial sector. Lending activity remains largely frozen and banks and the HFF, despite their expanding capital base and strong liquidity positions, could be still a source of significant liabilities. The households and the corporate sector are also in a limbo with unclear balance sheets and high debt burden, which impedes investment decisions and economic recovery and undermines tax bases. The level of government debt is also disturbingly high and needs to be brought down over the medium term in order to limit solvency and servicing risks. Finally, despite shielding the economy from possible foreign capital outflows, capital controls have widespread perverse effects on the structure of the economy and on economic policy and risk becoming entrenched if more resolute measures for their lifting are not taken.

Composition of the budgetary adjustment (% of GDP)

	2010	2011	2012	2013	2014	Change: 2011-14
Revenues	41.5	42.0	42.1	42.1	42.4	0.4
- Total taxes	30.8	31.7	31.6	35.8	35.9	4.2
- Other (residual)	10.7	10.3	10.5	6.3	6.5	-3.8
Expenditure	51.5	45.4	43.6	42.1	41.2	-4.2
Primary expenditure (1)	46.0	40.9	38.7	37.3	36.4	-4.5
of which:						
Gross fixed capital formation	2.9	-	-	-	-	-
Consumption	25.9	25.0	24.0	23.4	22.9	-2.1
Transfers & subsidies	9.6	-	-	-	-	-
Other (residual)	7.6	-	-	-	-	-
Interest payments	5.5	4.5	4.9	4.8	4.8	0.3
Budget balance	-10.1	-3.4	-1.4	0.0	1.2	4.6
- Cyclically adjusted	-	-	-	-	-	-
Primary balance (2)	-6.6	-0.6	1.9	3.3	4.4	5.0
Gross debt level	92.9	98.4	93.2	89.4	84.8	-13.6

Sources: Pre-Accession Economic Programme (PEP) 2012, ECFIN calculations
(1) Expenditure minus interest payments; (2) as defined by the PEP: total balance corrected for net interest

- Structural balance (cyclical component of deficit, one-off measures and temporary measures, fiscal stance)

The programme does not contain an estimation of the structural balance.

Budgetary implications of "major structural reforms"

The programme provides only very limited information about the budgetary impact of major structural reforms. A new bill on fisheries management (not yet adopted) is expected to bring significant budgetary revenue (see Box 1) and a reduction in the number of ministries from twelve to ten, and possibly to eight, could bring some minor savings on the expenditure side.

General government debt

A key objective of Iceland's economic programme is to bring the central government debt to 45-50% of GDP and the general government debt to 60% of GDP by 2020. The PEP projects a decrease of the general government debt to around 85% of GDP in 2014, which is in line with the fiscal scenario.

Projections on the decomposition of changes in the debt ratio over the PEP period reveal that the primary balance would increasingly be the main factor for debt reduction. In addition, the "snowball effect" (i.e. the combined effect of interest and nominal GDP growth) has a steady, although declining, debt reducing effect. The residual stock-flow adjustment remains rather small, with the exception of 2011 when the government decided to borrow the full outstanding amount of the bilateral loans negotiated with the Nordic countries. In March 2012, the central bank and the government prepaid around one fifth of their obligations toward the IMF and the Nordic countries. Although not reflected in the programme, the prepayment would reduce government debt by approximately 3.4% of GDP.

Composition of changes in the debt ratio (% of GDP)

	2010	2011	2012	2013	2014
Gross debt ratio [1]	**92.9**	**98.4**	**93.2**	**89.4**	**84.8**
Change in the ratio	5.0	5.5	-5.1	-3.8	-4.6
Contributions [2]:					
1. Primary balance [3]	**6.6**	**0.6**	**-1.9**	**-3.3**	**-4.4**
2. "Snow-ball" effect	**0.9**	**-2.9**	**-3.4**	**-1.3**	**-1.6**
Of which:					
Interest expenditure, net	3.4	2.9	3.4	3.3	3.2
Growth effect	3.4	-2.2	-2.2	-2.2	-2.4
Inflation effect	-5.9	-3.5	-4.6	-2.4	-2.4
3. Stock-flow adjustment	**-2.6**	**7.8**	**0.2**	**0.8**	**1.4**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

[3] As defined in the PEP: Budget balance corrected for net interest payments

Source: Pre-Accession Economic Programme(PEP); 2012 Commission Services' calculations

Future PEP submissions would benefit from presenting the currency and maturity structure of the debt, in addition to a sensitivity analysis linking debt scenarios (stock and servicing) to deviations of key economic variables from base assumption, such as GDP growth, inflation, exchange rates, interest rates (especially with a view to capital liberalisation). Iceland has regained its investment grade rating and is well-positioned to solidify its position on the international financial markets. However, the relatively high stock of debt and explicit and implicit contingent liabilities underline the need for a continuation of prudent fiscal policy and careful debt management.

3.5.3 Sensitivity analysis and comparison with previous PEP

The programme does not provide a sensitivity analysis of the impact of changes to main economic assumptions (e.g. GDP growth, revenue growth, interest rates, exchange rates) on the fiscal position. It nevertheless outlines potential risks stemming from very high contingent liabilities. State guarantees stood at around 80% of GDP in 2011 covering mainly the Housing Financing Fund and Landsvirkjun (the state-owned electricity-generating company). The financial situation of the power-generating company is satisfactory and its exposure to the volatility of aluminium prices has been reduced. On the other hand, risks related to the operations of the Housing Fund materialised in 2010, triggering a government recapitalisation amounting to some 2% of GDP. The Fund, to which about 70% of all state guarantees are extended, is still undercapitalised and remains a potential source of obligations for the government. The state could also be liable to pay an estimated ISK 15-30 billion (0.9-1.8% of GDP) arising from the merger of SpKef savings bank with Landsbanki and from settling the difference between assets and liabilities of SpKef.

The Icesave dispute represents a prominent contingent liability. In December 2011, the winding-up board of Landsbanki paid-out about one-third of all outstanding priority claims. In the same month, the European Free Trade Association (EFTA) Surveillance Authority took Iceland to the EFTA Court over a potential breach of the Deposit Guarantee Directive. Thus, the potential obligations for Iceland remain significant but uncertain. The PEP expects that sufficient assets would be recovered from Landsbanki's estate in order to cover all the priority or senior claims over the coming years.

As in the case of the government debt scenario, future PEP submissions would benefit from a proper sensitivity analysis of the fiscal balance to changes in some key economic variables. This would be useful in assessing the effects of possible deviations from the baseline macroeconomic scenario on the realisation of the medium-term fiscal programme and its targets. It would also underpin the achievement of sustainable public finances by providing the basis for corrective measures in case further deviations from the outlined fiscal path occur.

3.5.4 Quality of public finance and institutional features

The PEP presents a comprehensive overview of on-going institutional reforms, aiming to improve the quality of public finances. After the crisis exposed many of the weaknesses of the budgetary process and decision-making, Iceland has launched a thorough overhaul of the underlying legal basis, including its organic budget law. The new law has the ambition to lay the foundations for a sustainable fiscal policy and is set to be presented to the parliament in the spring of 2012. In parallel, Iceland is performing a gap analysis of its internal financial control and external audit in order to strengthen its financial control system and bring it closer to EU standards and best practices.

In 2011, the budget has set a two-year forward looking framework for binding nominal expenditure limits, provided price deviations would be less than 1.5 percentage points from assumptions, and coupled with an ISK 5 billion reserve to cover contingency expenditure. The rule was undermined by the collective wage agreements last year. Nevertheless, the programme foresees that it will remain in place, with a possible revision of the 2013-2014 ceilings in the spring of 2012. The rule would need to be implemented in practice, if it is to gain credibility in the future.

Special attention is devoted in the PEP to the quality of local government finances. Deficits and debts at local level have increased in the crisis, leading the authorities to pass a new law in the autumn of 2011, introducing fiscal rules at local level. It requires local governments to balance their budgets over each three year period. In addition, it introduces a limit on total debt of 150% of revenue to be achieved within 10 years. The law differentiates the required efforts and monitoring on the basis of these two criteria, the only exception being the City of Reykjavik because of the high debt of Reykjavik Energy, a local public utility company. According to the PEP, local governments would have to further consolidate their budgets, making a combined effort of 1% of GDP over three years until 2014. The new law on local government finances is certainly a step in the right direction and should help in the process of rebalancing local budgets.

The programme does not explicitly discuss the composition of budget revenue and expenditure. Consolidation requirements are carefully balanced with a need to support a more even income distribution. Looking ahead, the programme's revenue enhancing

measures look increasingly tilted towards the later goal, as it envisages higher taxation of the financial sector and of the rent in some sectors in the economy. Growth-enhancing expenditure, like public investment, has been reduced significantly in the crisis and is foreseen to remain at historically low levels over the programme horizon. Priority has been given to supporting public consumption, which is close to a turning point and may stop falling in 2012. This expenditure structure, although boosting short-term recovery and consumer confidence, is not conducive to sustainable long-term growth and may come under pressure for increasing government investments as the economy expands.

3.5.5 Sustainability of public finance

The PEP 2012-2014 does not discuss or provide information about long-term projections of population trends and age-related public expenditures. Therefore, it remains unclear to what extent the current health and social welfare system present a challenge for the long-term sustainability and how the medium-term policy strategy would respond to those challenges. Last years' PEP asserted a relatively favourable outlook for Iceland's pension system, in comparison with peer countries. Nevertheless, a government committee was set up to examine the financial burden from ageing population on the pension system in Iceland and to suggest possible avenues for future pension reforms.

3.6 STRUCTURAL REFORMS

3.6.1 Obstacles to growth and structural reform agenda

The PEP covers a broad range of structural reform areas with a view to improving the supply side of the economy and increasing its resilience. In the short term, the still precarious situation of the financial sector and the high household and corporate indebtedness are identified as major obstacles to a sustainable recovery. This is coupled with the problem of inefficient capital markets and existing restrictions on capital movement. As a medium to long-term challenge, the programme outlines the need for export diversification to alleviate overreliance on exports of marine products and aluminium.

3.6.2 Key areas of structural reform

Overall, the programme's set of measures to tackle policy priorities is broadly appropriate. Proper attention is given, in line with the Iceland 2020 strategy, to stimulating innovation and job creation and fostering regional development. However, the level of detail in presenting some of the measures is insufficient and the timeline and sequencing of measures are either lacking or not sufficiently elaborated upon.

Product and capital markets

The PEP touches upon a number of structural reform areas, such as enterprise sector restructuring, energy, competition and regional policies, with a special attention given to the financial sector. The state retains a major presence in the economy. It is the owner of all public utilities and in control of strategically important sectors, like the energy sector. The programme confirms that there are no plans for privatisation. The Treasury remains the main shareholder in Landsbanki, minority owner in the other two big banks and holds

important shares in several smaller savings banks. In the medium-term, it intends to profit from its involvement in the financial sector by collecting dividends or selling assets, although in view of the remaining problems in the sector, this assumption may prove optimistic.

In 2011, competition policy has been strengthened, notably to deal with dominant positions in different markets. No further policy changes in the field of competition are envisaged over the programme horizon. A new Energy Strategy has been developed to target reduction in consumption and imports of fossil fuels. It also prioritises the use of renewable energy and sets ambitious goals for the share of renewables in the transport sector, to be achieved by 2020. As part of its development agenda, the government is implementing a 2010-2013 regional development plan. The aim is to improve conditions for development throughout the country through measures supporting employment, investment, innovation and culture. In addition, a one-year regional transporting aid scheme has been introduced to promote the manufacturing industry and support growth in remote regions.

The PEP admits that despite significant progress in financial sector restructuring over the last few years, the sector continues to suffer from serious problems. A February 2012 decision by the Supreme Court of Iceland, judging illegal the retrospective interest payments on exchange-rate linked loans, is likely to further delay the completion of debt restructuring and increase its burden for the banks. Banks have high operating costs and the sector is highly concentrated, facing serious competition issues, which could only be worsened by mergers in the sector. Entry barriers are significant, according to the Competition Authority, and consumers cannot easily change their bank. The incentives structure in the sector is influenced by the fact that most of the owners of the banks are foreign creditors, through companies owned by the old banks' winding-up committees, which currently are 'locked-in' because of the capital controls. It is also not clear to what extent the debt restructuring has left the banks in position to either directly own or influence companies and some sectors of the economy experiencing debt problems. The Ministry of Economic Affairs is set to present a report to the parliament in 2012 on the future structure of the financial system, addressing some of these issues and setting a base for drafting concrete legislative proposals. The ministry and the central bank are also to explore the use of macro-prudential tools to strengthen the system. Further actions to improve the legal framework in the sector and coordination between different authorities are envisaged.

Labour market

Although the number of unemployed declined in 2011, the labour force has fallen as well and job creation remains a challenge. The government recognised the seriousness of the problem and launched a number of measures and programmes to improve the functioning of the labour market and soften the effects of the crisis on the unemployed. According to the PEP, among all programmes, participation in job training and training involving innovative projects have been the most successful as over 60% of the participants have been deregistered from the unemployment registry within three months of participation. On-the job training will continue in 2012, offering 1,500 jobs. Long-term unemployment, which reached historically high levels and represents about a quarter of total unemployment, is of particular concern. While the parliament extended the maximum eligibility period for unemployment benefits until the end of 2012, part of the efforts to decrease long-term unemployment has been channelled to the design of an education

programme for those unemployed for six months or longer. About 1,000 people applied for the programme in the autumn 2011 and received benefits during the first semester of their studies. Looking ahead, the PEP also outlines a number of additional measures to boost education, linking it more closely to the needs of the labour market. The programme does not comment on the wage setting mechanism in the country. In view of its importance for the labour market and overall economic performance, future submissions would certainly benefit from analysing it.

Other reform areas

Other reform areas cover the agricultural sector, public administration, FDI performance and private debt restructuring. The programme sketches a few ideas (on-going and planned) on how to increase administrative capacity and cooperation between government bodies. It also acknowledges the substantial differences between agricultural policy and instruments in Iceland and the EU but fails to address the question of how and in what timeframe Iceland would align itself to the acquis.

Although the PEP claims that households debt restructuring of exchange-rate linked loans have been completed, the recent Supreme Court decision judging illegal the retrospective interest payments on these loans, have effectively reopened the issue once again. This could also delay the envisaged completion of corporate debt restructuring beyond mid-2012. The restructuring of foreign currency loans remains unfinished as well, depending on the outcome of a number of court cases. The programme asserts the important role played by the Financial Supervision Authority and the Competition Authority in ensuring the fairness and efficiency of the corporate restructuring process. In order to provide the authorities with more information and support policy-making, Statistics Iceland has been entrusted to collect detailed information about indebted households and corporations, including about their payment difficulties and equity, which is expected to be published for the first time in 2012.

The PEP recognises the importance of investment for economic growth in Iceland. Foreign direct investments are currently still relatively low and heavily concentrated in a few sectors. In December 2011, the government submitted to the parliament a proposal for a resolution on foreign investment calling for transparency and clear regulations on FDI. If adopted, the proposal would also explicitly give the authorities a mandate to seek foreign investments which support economic diversification, environmental protection, research and development, high job creation and value added, use new technologies, create new opportunities and provide high tax revenue.

3.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

Chapter 2.1 presents a brief description of real and external sectors and labour market developments. Future submissions should also capture monetary and credit variables in a comprehensive manner. The medium-term macroeconomic framework in chapter 2.2 would benefit from an analysis of the medium-term prospects of the current monetary and exchange rate strategy. Exploring the links between the financial sector and the medium-term growth scenario and presenting alternative growth scenarios could also enhance the quality of the programme in the future. The PEP could assess as well the level of foreign reserves on the basis of standard liquidity and solvency indicators and,

more generally Iceland's net international investment position in the context of the capital liberalisation strategy. A more forward looking assessment of balance of payments developments and in-depth analysis of the sustainability of the external position and of competitiveness issues are also warranted. Weaknesses remain with respect to data on savings-investment balances.

Fiscal framework

Historical data on budget balances and debt are consistent with data provided in the context of the September 2011 fiscal notification. The programme would have gained clarity by providing more details about the 2011 budgetary execution and the policies and risks behind the medium-term budgetary framework. The PEP continues to have a strong emphasis on central government instead of general government operations. Future submissions would benefit from more complete data (e.g. on composition of general government revenue and expenditure, long term fiscal projections, cyclical budget balance). A sensitivity analysis should be added to the baseline fiscal programme to better understand risks to the scenario.

Structural reforms

The structural reform framework is coherent but the level of detail in presenting some of the measures is insufficient. The programme would also benefit from providing a clear timeline and sequencing of the planned measures, along with information about their estimated budgetary impact.

Annex: Structural indicators

	Iceland					EU 27				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
General economic background										
Real GDP [1]	6.0	1.3	-6.8	-4.0	3.1	3.2	0.3	-4.3	2.0	1.6f
Labour productivity [2]	96.5	100.9	100.2	93.8	n.a.	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-0.8	1.0	2.8	-1.6	-0.5f
Real effective exchange rate [4]	126.0	79.7	62.7	70.2	71.8	121.4	123.2	118.3	109.0	113.1
Inflation rate [5]	3.7	12.7	16.4	7.6	4.3	2.3	3.7	1.0	2.1	3.1e
Unemployment rate [6]	2.3	3.0	7.2	7.6	7.1	7.2	7.1	9.0	9.7	9.6
Employment										
Employment rate [7]	85.1	83.6	78.3	78.2	n.a.	65.3	65.8	64.5	64.1	n.a.
Employment rate - females [8]	80.8	79.6	76.5	76.2	n.a.	58.2	58.9	58.4	58.2	n.a.
Employment rate of older workers [9]	84.7	82.9	80.2	79.8	n.a.	44.6	45.6	46.0	46.3	n.a.
Long term unemployment [10]	0.2	0.1	0.4	1.3	n.a.	3.1	2.6	3.0	3.9	n.a.
Product market reforms										
Relative price levels [11]	148.9	116.8	100.8	110.3	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	26.7	31.7	30.5	32.7	35.0	10.7	11.6	9.8	11.7	n.a.
Net FDI [13]	-16.5	30.4	-18.2	20.7	8.1	3.9	2.2	2.1	1.0	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.6	0.6	0.6	n.a.
Business investment [16]	24.3	20.2	10.6	10.1	11.9	18.7	18.4	16.2	15.9	n.a.
Knowledge based economy										
Tertiary graduates [17]	10.2	10.4	10.3	n.a.	n.a.	13.8	14.5	14.3	n.a.	n.a.
Spending on human resources [18]	7.4	7.6	n.a.	n.a.	n.a.	5.0	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	52.9	53.6	53.6	53.4	n.a.	78.1	78.5	78.6	79.0	n.a.
R&D expenditure [20]	2.7	2.6	3.1	n.a.	n.a.	1.9	1.9	2.0	2.0	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	25.7	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs). 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Number of broadband access lines per 100 inhabitants.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources

4 THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

4.1 EXECUTIVE SUMMARY

The Pre-Accession Economic Programme for 2012 - 2014 (the "2012 PEP") of the former Yugoslav Republic of Macedonia was submitted on 31 January 2012. Its main objective is to improve the country's competitiveness by a broad rand of measures, such as enhancing the business environment, supporting SMEs, improving human capital and the functioning of the labour market, promoting exports, improving the efficiency of public administration, strengthening the rule of law and the capacities of supervisory institutions and improving the productivity in agriculture. These objectives are in line the country's challenges. The programme complies with the requested form. However, with respect to the presented content and the provided numeric underpinning, the document does not meet the standard expected from an advanced candidate country. Overall, the programme unfortunately is neither very helpful for presenting the authorities' medium-term plans, nor does it provide a solid base for policy decision.

The programme presents the macroeconomic outlook in the form of annual ranges. However, there is no central scenario and this range approach is not applied for the whole framework. So the government’s expectations for the programme period remain ambiguous and the analysis of the impact of different growth scenarios on other parts of the economy, such as inflation and external balances, appears incomplete. The programme's external projections do not seem to be entirely consistent with the growth scenario, which in the stronger growth scenario could result in wider external balances in 2013 and 2014. Contrary to the Commission's request, the programme neither presents a detailed assessment of the country's external sustainability nor of competitiveness issues. Overall, the macroeconomic scenario appears to be on the optimistic side, in particular for 2012. The fiscal strategy is not discernible as neither the public finance path over the years 2012 to 2014 nor the envisaged measures are made explicit. The structural reform agenda is very comprehensive but would have benefitted from a more explicit discussion of policy measures and their estimated impact on fulfilling the programmes objectives. The programme refers to the Europe 2020 strategy and defines national targets in some areas. It also addresses EU accession related priorities, although the translation of those priorities into concrete measures could have been presented in more detail. Overall, the usefulness of the programme for medium-term policy making appears limited, as the macro-economic scenario and the public finance path over the 2012-2014 period are ambiguous. Only limited and aggregated public finance data is provided for the whole period.

Real GDP growth accelerated from 1.8% in 2010 to 3% in 2011. In the first half of the year, output growth was at 5%, but economic activity decelerated markedly in the rest of the year. Inflation remained high in the first half of the year, reflecting strong demand but also high international food and fuel prices. Inflationary pressures decelerated in the second half of the year, leading to an annual inflation rate of 3.8%, compared to 1.6% in 2010. The trade deficit widened sharply in the first half of 2011, although lower domestic demand in the second half helped to contain the increase in trade deficit, from 21.3% of

GDP in 2010 to 23% in 2011. Inflows of current transfers remained stable at close to 20% of GDP. In line with the underlying dynamics in the trade balance, the current account deficit rose from 2.2% in 2010 to 2.8% in 2011. FDI inflows rose from 3% in 2010 to about 4% in 2011. The international investment position appears to have deteriorated markedly in 2011, reflecting increased reliance on foreign loans for financing mainly public spending. The cash-based central government deficit was at 2.6% of GDP, while the central government debt rose as a result of drawing on external sources. Unemployment dropped slightly, from 32% of the labour force in 2010 to 31.4% in 2011. Despite the overall relatively favourable macroeconomic performance, the key accession-related challenges remain: improve the functioning of the market economy in order to raise the country's potential growth and to reduce the extremely high level of unemployment. This requires further substantial improvements of the business environment, a strengthening of the rule of law and of institutional and administration capacities as well as efforts to enhance the quality of education.

The medium-term macroeconomic framework for the period 2012-14 is presented in the form of annual ranges for GDP growth. The upper boundary increases from 4% in 2012 to 4.7% in 2014. The lower boundary expects output growth of at least 3% in 2012 which will improve to at least 4% in 2014. Growth is expected to be mainly driven by domestic factors, in particular private consumption and investment. This appears optimistic, in particular given the limitations of raising disposable incomes. Import growth is seen to remain moderate, supporting a decline in external imbalances. In view of the strong underlying domestic demand, this improvement comes a bit as a surprise. Inflation is forecast to remain benign, while strong employment growth will help to reduce unemployment. Overall, there is a significant downside risk to the forecast in 2012, while in view of expected strong growth in 2013-2014, external imbalances could be much wider.

The preliminary central government deficit was 2.6% of GDP in 2011. However, the presented data is on cash-base only, not taking into account substantial payment arrears. Lower than expected revenue growth required adjustments on the spending side to meet the budget target. As in the past, the main adjustment took place in the area of public investment. The budget for 2012 is based on a rather optimistic growth scenario, expecting nominal GDP growth of about 7% and revenue growth of nearly 6%, based on already optimistic revenue estimates for 2011. The budget plans to contain current spending in order to increase capital investment. However, the programme misses details on how exactly this reorientation will be implemented. For the period 2013-14 the authorities envisage a deficit at 2.5% of GDP at most. However, the programme does not provide sufficient details, neither with respect to planned revenue and spending scenarios nor with respect to planned measures in order to achieve deficit targets. Furthermore, the PEP lacks a presentation of risk mitigation strategies, such as in case of lower than expected revenue growth or unexpected higher spending. The issue of risks to deficit financing is not adequately addressed. This renders it particularly difficult to assess the authorities' fiscal policy stance in the medium term.

The programme would have benefited from a more in-depth diagnosis of structural bottlenecks to growth, in line with the Europe 2020 strategy, as requested by the Commission. The main growth obstacles appear to be a weak business environment, resulting from an inadequate rule of law and insufficient judicial, regulatory, supervisory and administrative capacities, and, among others, a poorly educated labour force. The

programme puts slightly increased emphasis on these shortcomings. However, it would have benefitted from a clearer link between identified obstacles and policy measures and a concreter and more concise presentation of those reform measures. Furthermore, the document could have presented the reform measures in a more forward looking way, for example by specified concrete targets to be achieved.

The main risks to the programme are related to lower than expected growth, resulting from a further deterioration of the external environment, impeding export markets but possibly also affecting current transfers of citizens living abroad or temporary job opportunities in neighbouring Greece. Conversely, the rather high growth assumed in the programme is likely to lead to a widening of external imbalances and create pressure on the de-facto exchange rate peg to the Euro. On the other hand, lower growth could lead to a further deterioration in the labour market and require adjustments in the fiscal framework. In addition to the risk stemming from lower growth, the financing of the envisaged deficits primarily through external sources exposes the fiscal framework to risks related to the costs and availability of foreign financing. With respect to structural reforms, the main risks are related to delayed or stalled implementation.

Given the lack of detail with respect to the country's fiscal scenario, it is not possible to assess to which extent the presented structural reforms are in line with the budgetary framework. However, in view of the country's accession related reform requirements, the reform agenda would have benefitted from bolder measures and/or an approach with a stronger focus to key reform areas. In this respect, a better and more concrete integration between the fiscal framework and the reform agenda would have been helpful.

Comparison of key macroeconomic and budgetary projections

		2010	2011	2012	2013	2014
Real GDP growth (% change)	COM	1.8	3.0	2.5	3.5	n.a.
	2012	**1.8**	**3.5**	**3.0-4.0**	**3.5-4.2**	**4.0-4.7**
Consumer price inflation (%)	COM	1.6	3.8	2.5	3.3	n.a.
	2012	**1.6**	**3.9**	**2.5**	**2.5**	**2.5**
General government balance (% of GDP)	COM	-2.5	-2.5	-2.2	-2.0	n.a.
	2012	**-2.5**	**-2.5**	**-2.5**	**up to -2.5**	
Primary balance (% of GDP)	COM	-1.8	-1.8	-1.5	-1.3	n.a.
	2012	**-2.1**	**-1.8**	**-1.8**	**up to -1.8**	
Government gross debt (% of GDP)	COM	26.2	29.0	31.0	32.5	n.a.
	2012	**24.6**	**27.0**	**28.8**	**up to 28.8**	

Sources: Pre-Accession Economic Programme (PEP), Commission 2011 Autumn Forecast (COM)

4.2 INTRODUCTION [13]

The former Yugoslav Republic of Macedonia submitted its sixth PEP on 31th January 2012, covering the period 2012-2014. The programme has been adopted by the government. It is a joint document based on contributions from numerous line ministries and the Central Bank, under the coordination of the Ministry of Finance. Social Partners and the business community have been consulted on the draft document. The programme takes into account the 2012 budget and other national programmes, such as the National Development Plan, the Fiscal strategy for 2012-2014, the Investment strategy for 2012-14, the National Employment Strategy and the National Plan for the Adoption of the Acquis (NPAA). The document also refers to the country's accession process, the European Partnership priorities and the Commission's assessment in the Progress Report.

4.3 KEY CHALLENGES

Although the country weathered the global financial crisis rather well, the key policy challenges remain unchanged: addressing the underlying reasons for high structural unemployment, in particular among the young, improving the business environment in order to foster investment and job creation and improving the quality of public finances. Furthermore, improving the country's productivity and competitiveness are important challenges in order increase the country's growth potential over the medium term.

With respect to the country's accession perspective, important challenges continue to be to improve the functioning of the labour market, to strengthen administrative capacities and regulatory and supervisory agencies and improve the rule of law and contract enforcement.

4.4 RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

4.4.1 Recent macroeconomic developments

In the first half of 2011, output growth was at around 5% year-on-year, compared to 0% in the same period a year before. The main sources of growth have shifted from investment in the second half of 2010 and the first quarter of 2011 to private consumption in the second quarter of 2011 Besides a base effect a significant part of the domestic recovery appears to reflect front-loaded public spending ahead of general elections in June, in particular in the area of construction but also in the form of early execution of transfer payments, usually planned towards the end of the year.

On the back of strong domestic demand, the current account deteriorated, from 2.3% of GDP in 2010 to around 2.8% of GDP in 2011. This deterioration largely reflects a widening of the trade deficit to 24% of GDP, resulting from strong imports, while the export dynamics decelerated. Capital inflows in the form of current private transfers

[13] The ECOFIN Council of 26/27 November 2000 invited the Commission to *"report each year to the Council (Ecofin) on its assessment of the Pre-accession Economic Programmes*". The Council Presidency conclusions adopted last year can be found at: http://register.consilium.europa.eu/pdf/en/11/st09/st09654-re01.en11.pdf

remained high at some 20% of GDP and largely financing the trade deficit. A significant part of the financing of the current account deficit was covered by drawing about half - i.e. some 3% of GDP- of an IMF Precautionary Credit Line.

The preliminary general government deficit was at -2.6% of GDP in 2011. However, revenues were significantly below expectations, which – in combination with higher than expected spending for social security and subsidies – allowed the realisation of only some 76% of the planned capital spending.

Inflation accelerated in the first five months of 2011 and decelerated afterwards, coming down to 2.8% in December, compared to a peak of 5.8% in May. However, annual average inflation was markedly higher than a year before, at 3.9%, compared to 1.6% in 2010. The main factors behind the price increase were strong prices rises for food, rents but also energy.

Official labour-market data point to a continued, albeit decelerating increase in overall employment. Employment appears to have increased markedly in agriculture and manufacturing. The former is probably due to government incentives to register so far unregistered employment. Unemployment continued to drop slightly, but still remained at the high level of around a third of the labour force with youth unemployment at some 56% of this age group's labour force.

The exchange rate of the Denar has remained largely unchanged against the euro at a level of 61.5 MKD/EUR. The Central Bank intends to maintain its current informal peg to the euro.

4.4.2 Medium-term macroeconomic scenario

Instead of providing precise annual projections, the programme presents its medium-term scenario for the period 2012-2014 in the form of annual ranges. The upper boundary for GDP growth is seen at 4% in 2012, which will further accelerate to 4.7% in 2014. The lower boundary expects output growth of at least 3% in 2012 which will accelerate to at least 4% in 2014. In view of rather cautious assumptions on the international environment, growth is expected to be mainly driven by domestic factors, in particular private consumption and investment. Despite this strong reliance on domestic demand, import growth is surprisingly forecast to decelerate significantly, as compared to 2010 and 2011. At the same time export growth is expected to re-accelerate, benefitting from expected stronger exports of recently established foreign investments and contributing to a slightly declining trade deficit in percent of GDP. The current account is forecast to improve from -4.8% in 2012 to -3.7% in 2014. Inflation is forecast to remain at around 2.5% during the programme period, seemingly independent from the actual growth profile. Employment growth is seen to accelerate from 2% in 2012 to 3% by 2014. However, as a result of a similar increase in labour supply, the impact on the unemployment rate will be limited, lowering the rate from 30.1% in 2012 to 28.1% in 2014.

Overall, the upper boundary of this growth profile is rather on the optimistic side, while the lower profile appears more plausible. In particular, assumptions on growth of private consumption appear rather optimistic, as the growth of disposable income is limited by low wage growth and the fact that up to now a large share of the newly registered employment probably does not reflect newly created jobs but just improved registration.

Furthermore, the expected import growth profile looks rather subdued, given the projected strong growth of domestic demand and the high import content of envisaged investment. Presenting two different scenarios would have improved the clarity of the programme.

Comparison of macroeconomic developments and forecasts

	2010		2011		2012		2013		2014	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	1.8	**1.8**	3.0	**3.5**	2.5	**3.0-4.0**	3.5	**3.5-4.2**	n.a.	**4.0-4.7**
Contributions:										
- Final domestic demand	-0.6	**-0.7**	2.7	**4.9**	2.9	**4.3-4.7**	5.2	**4.5-5.1**	n.a.	**5.1-5.8**
- Change in inventories	1.2	**n.a.**	0.0	**n.a.**	0.0	**n.a.**	0.0	**n.a.**	n.a.	**n.a.**
- External balance of goods and services	2.5	**2.5**	0.3	**-1.5**	-0.5	**-1.3-0.7**	-1.7	**-1.1 to -0.9**	n.a.	**-1.0 to -1.1**
Employment (% change)	1.3	**1.3**	2.5	**3.0**	2.0	**2.0**	3.0	**2.5**	n.a.	**3.0**
Unemployment rate (%)	31.8	**32.0**	30.5	**30.8**	30.0	**30.1**	28.5	**29.2**	n.a.	**28.1**
GDP deflator (% change)	2.2	**1.6**	1.8	**3.6**	3.9	**2.8**	4.7	**2.4**	n.a.	**2.5**
CPI inflation (%)	1.6	**1.6**	3.8	**3.9**	2.5	**2.5**	3.3	**2.5**	n.a.	**2.5**
Current account balance (% of GDP)	-2.2	**-2.2**	-5.5	**-4.8**	-5.5	**-4.8**	-6.5	**-4.6**	n.a.	**-3.7**

Sources: Pre-Accession Economic Programme (PEP); Commission 2011 Autumn Forecast (COM)

Real sector

Compared to the Commission's Autumn forecast, the PEP scenario is clearly more optimistic for 2012, in particular with respect to the strength of domestic demand, but also expecting a rather benign performance of the country's external balances. In 2013, expectations with respect to domestic demand growth are more similar, while the PEP scenario is more optimistic with respect to containing the deterioration of external balances.

In contrast to the Commission scenario, the PEP uses ranges to indicate upper and lower boundaries to the country's growth profile. However, this approach has not been used for the projections of price developments, the labour market and the external balances which raises questions of consistency.

Potential GDP growth is estimated to be at 3¾%, using a standard Hodrick-Prescot method. This implies that in 2012, at least in the lower bound scenario, the economy might still operate below potential, while 2013 and 2014 the expected range of growth is mainly above potential growth. (However, realised average GDP growth during the last 10 years has been around 3%).

The situation in the labour market is expected to benefit from rather strong output growth, which should allow employment growth rates between 2-3%. This is expected to bring unemployment rates down to around 30% or 28%, respectively. Real wages are expected to increase by some 0.5% to 3%.

Inflation

Inflation is expected to remain contained. After a marked increase in 2011 to 3.9%, lower energy and food prices, as well as lower import prices are expected to help bring down inflation to around 2 - 2.5% during the programme period. The programme does not mention the possibility of inflationary pressures from the demand side, despite

expectations of above-potential growth. Risks are seen to be mainly on the downside, reflecting the risk of lower growth in the EU and its negative impact on the domestic economy. The Central Bank is expected to continue its policy of maintaining price stability. While the inflation outlook of the programme appears largely consistent with the lower range of the growth profile, some elements of the programme suggest the risk of inflationary pressures. For example, the programme points to the possibility of strong wage increases, which not only could impede competitiveness but also lead to rising costs of living.

Monetary and exchange rate policy

The monetary framework underlines price stability as the overarching monetary policy objective. To this end, the central bank maintains a de-facto fixed peg of the denar towards the euro. In view of the high share of euro-denominated imports (some 60% of total imports) this helps to contain price pressures through imports. The peg to the euro also contributes to curtail balance sheet risks as a large share of assets and liabilities are denominated in euro. No changes to the current exchange rate regime are envisaged. Overall, the monetary framework is in line with the programme's objective of maintaining a nominally fixed exchange rate towards the euro.

External sector

During the last 5 years, the current account deficits moved largely in line with underlying GDP growth, reaching -12.8% of GDP in 2008, when output growth was 5% and declining to -2.2% in 2010, when GDP growth was 1.8%. In 2011, the current around deficit rose to -2.8%, in line with stronger GDP growth of 3.0%. However, the usually rather low current account deficit hides persistently high trade deficits, amounting to more than 20% of GDP, which are largely compensated for by a similar amount of inflows of current transfers. Furthermore, the financing of the current account deficit is increasingly relying on foreign credit, while the level of FDI has remained very low, at around 3%-4% of GDP.

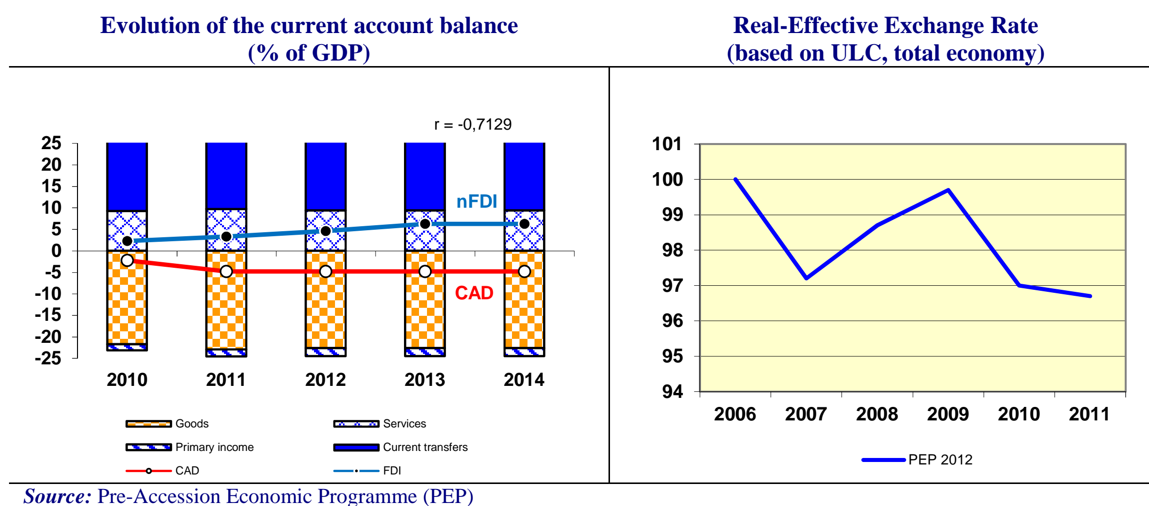
For 2013-14, the programme expects a marked decline in the trade and current account deficits, from 4.8% of GDP in 2011 to 3.7% in 2014. The profile reflects to a large extent very moderate import growth but also expected increased export activities of prospective foreign investors. These two factors should result in a fall of the trade deficit, from 23.5% of GDP in 2011 to some 20 % in 2014, which should support a similar improvement in the current account balance. No major changes are expected in the case of the other current account components. In particular with respect to the surplus in current transfers, only a minor deterioration is envisaged

The programme expects a structural improvement in the composition of exports due to recent and ongoing foreign direct investment, in particular in the area of chemistry and car manufacturing, which will also translate into an increased export potential. If materialised, this FDI driven improvement would be a welcome development, in particular, as in the past a high import content of exports tended to prevent any substantial improvement in the trade balance.

The programme does neither include a discussion of the long-term sustainability of the country's external balances, as requested by the Commission, nor a discussion on the

financial market. The absence of this discussion is an important shortcoming, given the currently high degree of uncertainty with respect to the global economy in general and with respect to international financial markets in particular.

Chart 1: **External competitiveness and the current account**



Source: Pre-Accession Economic Programme (PEP)

Financial sector

Overall, the country's financial sector has remained rather solid in recent years. However, a number of issues for discussion remain, such as the relatively low level of financial intermediation, the high exposure of debt to the euro and also the risk of a negative spill-over from the crisis in neighbouring Greece. The programme is rather silent on those issues.

Main risks to the macroeconomic scenario

The programme mainly points to the uncertainties related to the global situation, in particular the sovereign debt crisis in the EU. The programme argues that the authorities are monitoring international developments and are ready to intervene if necessary. However, the programme does not provide more details on measures the authorities intend to take in case adverse international developments take place.

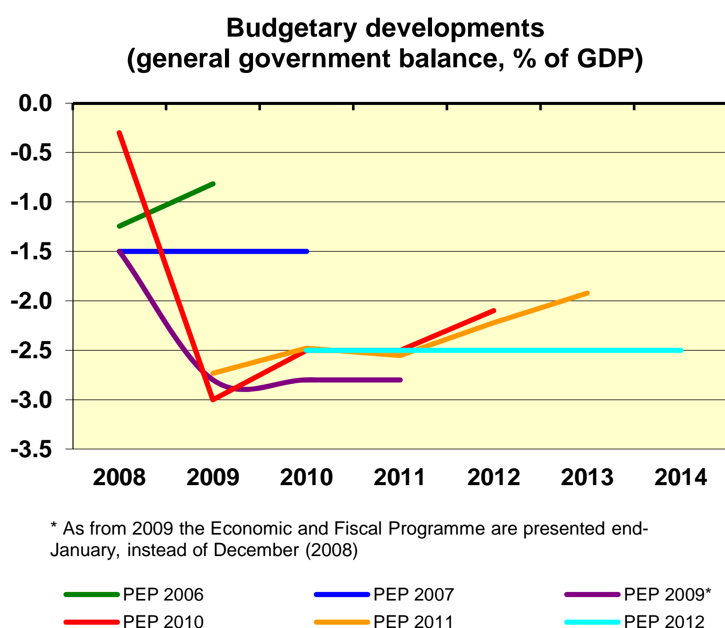
Furthermore, the programme does not mention any risks related to the domestic economy, such as higher inflation, which would erode disposable income and thus lower private consumption. On the external side, the programme could have discussed in more details scenarios analysing the impact of a significant decline in current transfers, of pressures on the country's exchange rate regime, but also risks related to marked decline in export markets or a possible spill-over of the crisis in neighbouring Greece.

4.5 PUBLIC FINANCE

The programme claims to envisage during the programme period a moderately expansionist fiscal policy, in order to bolster expected negative international environment, while in the medium term the authorities are committed to a sustainable fiscal framework. In terms of revenue, the authorities intend to keep tax rates unchanged,

while lowering social security contributions in order to reduce the tax wedge. On the expenditure side, the programme envisages reductions of current spending, with the notable exception of subsidies for agriculture which are set to rise, while capital spending will be increased as a share of GDP. Furthermore, increased funds will be used to implement projects with IFIs and international donors. Overall, deficits are planned to remain below 2.5% of GDP. The country has a solid track record of meeting its deficit target, albeit often the targets are met by cancelling capital investment projects.

However, in recent years, the authorities tended to overestimate revenue performance, which required the adoption of supplementary budgets during the year in order to cut planned spending accordingly. The most notorious area of spending cuts has been capital investment, where the authorities regularly announce major spending increases while realised spending tends to be significantly lower, usually at level of some 3% of GDP.



4.5.1 Budget implementation in 2011

The programme presents data for the first nine months of 2011, reporting an increase in total revenues by 4% year-on-year, while spending was 6.4% higher than in the same period a year before. Based on expected GDP growth for 2011 of 3.5% and inflation of 3%, revenue and spending were envisaged to increase by 7% and 7.2%, respectively On the revenue side, the main source for growth was VAT revenue, rising by 11%, while profit taxes and personal income taxes showed even higher increases. However, the latter two categories account for only 10% of total revenues, compared to nearly 30% in the case of VAT. On the expenditure side, the share of transfers remained rather constant at some 60% of total spending, while spending for wages and goods and services dropped as a share of GDP. Spending on subsidies for agriculture rose markedly, in particular in the first half of the year. Spending for capital investment increased from 2.5% of GDP in the first nine months of 2010 to 3% of the estimated full-year GDP in the first nine months of 2011.

In view of snap elections in June, the authorities seem to have front-loaded spending, such the disbursement of transfer payments, usually disbursed towards the end of the year. As a result, spending in the first half of 2011 was markedly higher, while in the second half spending was lower than a year before, compensating higher spending in the first half. Despite the less favourable fiscal performance, in particular in the first half of the year, achieving the 2011 deficit target of -2.5% of GDP appeared feasible at the time of the drafting of the PEP. In the meantime, available data for the full year of 2011 confirms this view. Overall, despite being successful in meeting fiscal targets, the quality of fiscal policy suffered from notoriously overly-optimistic revenue projections and a short-term orientation of spending decisions.

4.5.2 Near-term and medium-term budget strategy

The parliament adopted on 3 January the central government budget for 2012, envisaging a deficit of 2.5% of GDP. The budget is based on a rather optimistic expected real GDP growth of 4.5% and a projected inflation of 2.5%, bringing nominal GDP growth to about 7%. Central government revenues and expenditures are planned to increase by 5.6%. The budget does not envisage changes to the tax rates, but foresees a reduction in social security contribution rates. On the spending side, current spending on capital investment is planned to be increased by 29%, while spending on current expenditures will be contained as a percentage of GDP. Furthermore, the authorities intend to implement a series of investment projects and structural reform projects, such as in the area of education but also agriculture, co-financed by various IFIs and donors.

In relation to GDP, total revenues are expected to decline marginally from 34.4% of GDP in 2011 to 34.3% in 2012. Social contributions are expected to fall by 0.1 percentage point as a share in GDP. Tax revenues will increase by 0.2 percentage points of GDP, largely due to a strong increase in property income, due to a programme in selling state land. On the spending side, the level of spending in relation to GDP is expected to remain constant. However, in order to allow for an increase in capital spending by 0.8 percentage points of GDP, the 2012 budget intends to lower collective consumption by 0.2 percentage points of GDP and social transfers and subsidies by 0.3 percentage points of GDP, each. However, the programme does not provide detailed information, on how the authorities intend to achieve these spending reductions.

Overall, given the country's track record of achieving its deficit target, the envisaged central government deficit of 2.5% of GDP appears feasible, but may require again budget adjustments in the course of the year. Like in the past, the planned revenue growth appears to be optimistic. It thus looks rather likely, that in the course of 2012, measures will have to be taken to respond to the lower than expected revenues. On the expenditure side, the planned increase in public investment is described in a rather general way, without providing details on planned projects. Given the country's track record of underperforming spending targets in this category, it appears likely that this year again, it will not be possible to meet the intended spending targets.

The budget for 2012

* The parliament adopted the central government budget on 2 January 2012, envisaging a deficit of 2.5% of GDP.

* Revenues as percentage of GDP are expected to remain largely unchanged. On the revenue side, the budget envisages marginal revenue losses due as a result of reduction in the social security contribution rates. Table 2 in the annex specifies a number of expected revenue increases, but fails to indicate in which areas the authorities expect lower revenues, leading to the expected drop in the revenue share by 0.1% of GDP.

* On the expenditure side, the budget plans to raise spending for investment, which will be financed by reducing current spending accordingly. Unfortunately, the document does not provide details on how these spending reductions will be achieved.

Table: Main measures in the budget for 2012

Revenue measures*	Expenditure measures**
• Property income (e.g. sale of state land) (+0.4% of GDP) • Reduction in social security contribution rates (-0.1% of GDP) • Other non-specified net-effects (-0.4% of GDP)	• Social transfers (-0.3% of GDP) • Subsidies (-0.3% of GDP) • Collective consumption (-0.2% of GDP) • Gross fixed investment (+0.8% of GDP

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Source: PEP 2012

For the period 2013-2014, the programme only presents upper boundaries for expected revenues and spending. With respect to spending according to function no information is provided at all for this period. The overall intentions for this period seem to be maintaining largely the revenue and expenditure structure of the year 2012, or at least not increasing total revenues or spending as a share of GDP beyond the level achieved in 2012. Based on this provided information and due to the lack of a presented fiscal path or even a lower boundary, it is not possible to assess the fiscal policy stance for this period.

Given the country's policy challenges with respect to increasing per-capita income levels by fostering investment and addressing the particularly high unemployment, bolder and more focussed reform steps seem warranted. The main risks appear to be on the revenue side, as weaker than expected growth could lead to shortfalls of in particular VAT revenues or income taxes. Furthermore, there are non-negligible risks of rapidly increasing costs of deficit financing or even access to international financing. The programme does neither discuss risks nor fall-back options for its fiscal framework which is an important shortcoming.

Composition of the budgetary adjustment (% of GDP)					
	2010	**2011**	**2012**	**2012-2014**	**Change: 2012-14**
Revenues	32.0	34.4	34.3	up to 34.3	n.a.
- Taxes and social security contributions	23.4	27.0	27.1	up to 27.1	n.a.
- Other (residual)	8.6	7.4	7.2	up to 7.2	n.a.
Expenditure	34.6	36.9	36.9	up to 36.9	n.a.
- Primary expenditure	34.1	36.2	36.2	up to 36.2	n.a.
of which:					
Gross fixed capital formation	4.0	5.2	6.0	up to 6.0	n.a.
Consumption	12.8	13.1	12.9	up to 12.9	n.a.
Transfers & subsidies	16.9	17.8	17.2	up to 17.2	n.a.
Other (residual)	0.3	0.1	0.1	up to 0.1	n.a.
- Interest payments	0.6	0.7	0.7	up to 0.7	n.a.
Budget balance	-2.5	-2.5	-2.5	up to -2.5	n.a.
- Cyclically adjusted		-0.3	0.1	-0.1 to 0.3	n.a.
Primary balance	-2.1	-1.8	-1.8	up to -1.8	n.a.
Gross debt level	24.6	27.0	28.8	up to 28.8	n.a.

Sources: Pre-Accession Economic Programme (PEP), ECFIN calculations

Structural balance (cyclical component of deficit, one-off measures and temporary measures, fiscal stance)

The programme presents very briefly cyclically adjusted balances. According to the programme's calculations, the economy realised a negative output gap in 2010 and 2011. However, depending on the realised growth in 2012-2014, the economy is likely to grow around potential in 2013 and above potential in 2014. According to those calculations, the fiscal stance was slightly counter-cyclical in 2010 and 2011, and would be pro-cyclical in the remaining programme period, unless the authorities lower the deficit markedly below the 2.5% of GDP boundary. Furthermore, the calculations point to a rather high and increasing structural deficit of more than 2¼% of GDP.

Overall, the cyclical adjustment appears plausible with respect to the country's current position in the cycle. Concerning the size of the output gap and in particular the speed of closing the gap, the programme's estimates appear rather optimistic. The programme does not present details on one-off or temporary measures. In case the country can realise sustained stronger growth than in the past, achieving deficits of some 2½% of GDP is not necessarily a threat to the country's long-term sustainability. However, given the uncertainty of the country's growth profile and the risk related to the costs and availability of international and domestic finance, a fiscal stance geared towards medium-term balanced budget would be more in line with the country's long term sustainability. In this respect, it would be of particular importance to use public funds in a manner to increase the country's growth potential.

Budgetary implications of "major structural reforms"

The estimated net-effect of major structural reforms will have a minor impact on the country's fiscal position. The programme expects a temporary annual increase in public spending by about ½% of GDP during the programme period.

General government debt

The programme envisages an increase in the central government debt ratio14 from 27.0% of GDP in the third quarter of 2011 to 28.8% end of 2012. For 2013-2014, the authorities expect no further increase in the debt ratio. The main driving forces are the primary deficit, increasing in 2012 the debt ratio by 1.8 % of GDP and (unspecified) stock-flow-adjustments, increasing the debt ratio by 1.3 % of GDP in 2012. Interest rate spending will raise the debt ratio by 0.7% of GDP. On the other hand, expected real GDP growth of 4.5% in 2012 will reduce the debt ratio by 1.2 percentage points, while inflation of 2.5% will reduce the debt ratio by 0.7% percentage points. Thus, overall, the combined effect of interest payments, real growth and inflation (the so-called "snowball effect") will lower the debt ratio by 1.8 percentage points of GDP in 2012. The programme would have been expected to provide more information on the stock-flow-adjustment.

Composition of changes in the debt ratio (% of GDP)

	2010	2011	2012	2013-2014
Gross debt ratio [1]	**24.6**	**27.0**	**28.8**	**up to 28.8**
Change in the ratio	0.7	2.4	1.8	up to 1.8
Contributions [2]:				
1. Primary balance	**2.1**	**1.8**	**1.8**	**up to 1.8**
2. "Snow-ball" effect	**-0.1**	**-1.1**	**-1.3**	**n.a**
Of which:				
Interest expenditure	0.7	0.7	0.7	up to 0.7
Growth effect	-0.4	-0.9	-1.2	n.a
Inflation effect	-0.4	-0.9	-0.7	n.a
3. Stock-flow	**-1.3**	**1.7**	**1.3**	**n.a**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accru

Source: Pre-Accession Economic Programme(PEP); Commission services' calculations

The programme indicates that in 2013-2014 the central government debt ratio is expected not to increase beyond 28.8% of GDP, despite plans to increase credit financed public investments into transport infrastructure and energy. The energy investments are planned to be channelled through state owned companies and thus might not affect central government accounts. However, when looking at general government balances, those investment projects probably would lead to a marked increase in the public debt ratio.

[14] The presented debt is only central government debt, i.e, does not include the debt of state companies, which might add some 5% of GDP to the presented debt level.

The public debt management is done by a separate department in the Ministry of Finance. For the programme period, the 2012-2014 fiscal strategy defines guidelines for central government debt, with an upper limit of 35% of GDP and of 45% of GDP for total public debt, i.e., including debt of state companies but also the Central Bank. In September 2011, the share of domestically financed central government debt was about 32% of central government debt, or 7% of GDP. The programme, however, does not specify its medium-term plans with respect to the debt structure. Contingent liabilities accounted for some 4% of GDP in September 2011 and seem to be no major threat to the country's fiscal sustainability. A bigger risk seems to be the high share of foreign denominated debt, accounting for some 70% of total debt. Furthermore, the fiscal strategy requires that at least 70% of foreign debt should be denominated in Euro, which translates into a quite high dependence on the exchange rate of a single currency. The programme would have benefitted from providing data on the maturity structure and the currency composition of foreign denominated debt.

4.5.3 Sensitivity analysis and comparison with previous PEP

The programme presents a brief sensitivity analysis of the impact of lower growth on the deficit and of interest rate and exchange rate shocks on debt. With respect to GDP growth, the programme assumes that a less favourable international environment would lead to lower exports and thus lower production. According to those simulations, GDP growth rates which are a quarter lower than in the scenario would increase the central government deficit by 0.2 to 0.4 percentage points, to 2.7% to 2.9% of GDP. Overall, these estimates look plausible, in particular in view of the limited impact of exports on revenues. However, it would have been interesting to simulate the impact of shocks with a higher fiscal sensitivity, for example a drop in private consumption as a result of a sharp fall in current transfers.

The analysis of interest and exchange rate shocks finds that an increase in the interest rate by 1 percentage point would raise the costs of debt financing by up to 14 %, reflecting the high share of debt based on variable interest rates. With respect to exchange rate shocks, the simulation tested the effects of a 10% appreciation and depreciation of the Euro in relation to other currencies. Like in the previous programme, the analysis of the exchange rate risk points to a relatively low risk stemming from the volatility of non-euro currencies, affecting debt servicing costs by up to 2%. However, the analysis would have benefitted from a broader approach, e.g. also taking into account the hypothetic possibility of pressure on the current exchange rate to the euro, which is the currency in which about 60% of the country's public debt is denominated. Overall, the sensitivity analysis provides interesting insights. However, given recent turbulences on international capital markets, the document would have benefitted from a more thorough analysis, including a discussion of risks related to the access of international financial markets, but also more long-term risks, related to contingent liabilities, payment arrears, the aging of the population. In particular, the programme does not provide information on possible fall-back positions for mitigating unfavourable developments.

4.5.4 Quality of public finances and institutional features

The programme refers to plans to improve the quality of public finances by shifting spending from less productive use to capital investment, in particular transport

infrastructure and by increasing efficiency in using budget funds. However, the programme does not provide much concrete information on actual revenue and expenditure measures in order to achieve those objectives.

The quality of budgetary planning still seems to be weak, leading to recurring significant deviations between budgetary plans and their execution. In particular, the repeatedly announced reorientation from current spending to capital investment appears to be regularly hampered by lower than expected revenues. In contrast to previous submissions, the 2012 PEP only provides very general information on the expected performance of revenue and spending items, in particular with respect to the time range beyond the 2012 budget. Furthermore, there seems to be no progress in improving expenditure managements of multi-annual budgeting, which would be important for medium-term capital investment. The programme points to plans on joint investment projects, co-financing IFI and IPA projects. However, the document is very parsimonious with respect to providing concrete spending estimates, in particular with respect to investment plans.

The revenue side of the central government's budget is dominated by VAT revenues and social security contributions, accounting for about 45% and 30% of total revenues, respectively. Furthermore, income taxes and dividends from state shares in the country's telecom company are other significant sources of revenues, accounting for about 10% and 5% of total revenues, respectively. On the spending side, social transfers and subsidies account for about half of total spending, while another 37% of total spending are used for public consumption. Capital spending accounts for about 12% of total spending (around 4% of GDP) while spending on debt services accounts for less than 2% of total spending. Despite repeated plans to shift spending from current expenditures to capital investment, the spending structure has remained rather stable in recent years. The document does not provide detailed information on the composition of public investment. However, there seems to be significant room for improving the growth and employment impact of public spending. Concerning aligning the country's statistical system with ESA 95, the programme refers to a current IPA project with its implementation phase 2010-2012. However, besides listing a number of directives to be transposed, the 2012 PEP does not provide any information on the actual progress in this area.

4.5.5 Sustainability of public finances

The programme presents long-term estimates on the sustainability of public finances for the period up to 2060. The scenario expects an increase in economic growth up to 2030, from annual GDP growth of 1.8% in 2010 to 4% in 2020 and to 4.6% in 2030, and a deceleration afterwards, with growth rates at around 3.7%. Unemployment is expected to decline gradually, from 32.2% in 2010 to 8% in 2060. The decline appears to be rather linear, expecting unemployment rates of less than 10% in the period 2050-2060 only. Central government revenues are expected to decline only marginally, dropping from 33.6% of GDP in 2010 to 33.3% in 2060, while the share of central government expenditure in GDP is forecast to drop slightly faster, from 35.9% of GDP in 2010 to 33.5. As a result, the deficit will drop, from 1.4% in 2020 to close to zero in 2060.

Expenditures for pensions are expected to increase slightly in the period up to 2030, from 8.9% of GDP in 2010 to 9% in 2020-2030 and to decline to 8.7% by 2060, reflecting the increased relevance of private pension funds. Health expenditures are set to increase

slightly, from 4.5% of GDP in 2010 to 4.9% towards the end of the period. Spending for education is projected to rise slightly less than in the previous programme, from 4.6% of GDP in 2010 to 5% of GDP in 2060.

The document is rather benign with respect to any major and immediate threats to the long-term sustainability of the country's public finances, mainly relying on the country's relatively low debt level and the track record of maintaining low deficits. Surprisingly, demographic pressures are not seen as major medium-term risk, although the presented data points to a marked and stable increase of pension-age population, from 9.7% of the total population in 2010 to 12.3% in 2060. Furthermore, the programme points to the recent introduction of a second (private) pension pillar which should help to contain public spending pressures in the medium-term. However, social security contributions are likely to decline accordingly, which thus could nevertheless create pressure on the financing of public pension funds. Health-related spending is also likely to increase at least in line with the aging population. Overall, the programme is optimistic on the ability to meet those costs. However, in view of a rapidly increasing share of old-age population, the financial viability of the public pension and health-care systems should be monitored carefully.

4.6 STRUCTURAL REFORMS

4.6.1 Obstacles to growth and the structural reform agenda

The document does not explicitly elaborate on structural obstacles to growth, as requested by the Commission, but only refers to the challenges of reducing unemployment and increase growth. As discussed in the various Commission's progress reports and following the analysis of a number of international institutions, key obstacles to growth appear to be weak institutional capacities, in particular problems with the rule of law, the poor quality of public services, impeding investment, and the low level of qualification of the country's labour force, hampering job creation.

The presented reform measures should, once fully implemented, have a positive impact on those obstacles to growth. However, the programme does not provide a clear picture what exactly the authorities intend to do, which targets the authorities plan to achieve and even more importantly, when those targets are going to be met.

4.6.2 Key areas of structural reform

The 2012 PEP identifies the following key reform areas: (1) improving the business environment, (2) support of enterprises and in particular of SMEs, (3) reduction of unemployment, (4) improving human capital, (5) functioning of labour market and increased (6) export support and promotion.

The programme presents its reform agenda in the context of the Europe 2020. Overall, the choice of the reform priorities appears broadly appropriate. The document provides detailed data on the budgetary impact of the presented reform measures. However, probably due to the small net budgetary impact, this link is not noticeable when analysing the presented fiscal framework. Annex 3 of the document contains a matrix with policy commitments, including information on the various spending flows per year.

However, a number of projects appear to be budgeted for 2012 only. The presentation in the text usually does not specify the time profile for the implementation of those reform projects. The spending peak seems to be in 2013, with a decline in absolute terms and even more when expressed in terms of nominal GDP. However, a large part of structural reforms is financed by international financial institutions and donations, among others also from the EU budget, which by definition is not included in the presentation of a net-budgetary impact.

Net direct budgetary impact of key reform commitments (in EUR million)			
	2012	**2013**	**2014**
Business environment	-0.2	-0.1	0.0
Enterpreneurship & SMEs	-0.7	-0.5	-0.6
Labour market	-11.1	-10.6	-10.2
Education	-17.4	-32.9	-36.8
Export promotion	0.0	0.0	0.0
Energy and Transport	-0.2	-0.4	-0.3
Other reforms (public administration, knowledge-based society, judiciary, envrionment, public procurement etc)	-15.6	-3.9	5.7
Total impact on the budget	-45.3	-48.4	-42.3
Total impact on the budget (in % of GDP)	-0.6	-0.6	-0.5

Source: 2012 Pre-accession Economic Programme (PEP), ECFIN calculations

Product and capital markets

The document presents a large number of structural measures to improve the efficiency of product and capital markets. The main measures are intended to simplify and accelerate procedures for business entry and exit, enhance dispute mediation, improve communication between the authorities and the business sector, facilitate access of SMEs to financial capital, to increase efforts to fight unfair competition, to strengthen and improve the alignment of the financial banking and non-banking sector regulation and supervision with European standards. Overall, most of the presented measures are important steps towards improving the country's business environment and do respond to the country's key challenges. However, the majority of presented reforms is related to legal matters, while the main financial costs are probably related to building up necessary administrative capacities of the public administration and of regulatory and supervisory institutions. In the area of product market reforms, the presentation in the PEP makes it difficult to assess the concrete implementation as well as the impact on the functioning of the country's product markets. The link between the envisaged policy measures and the programme's core objectives could have been established in a clearer way. Furthermore, the programme could have presented the current state and plans related to privatisation.

Labour market

In order to address the persistently high structural unemployment, the authorities intend to improve the quality of education and training and to foster job creation by supporting self-employment, by subsidising certain categories of employment, strengthening labour market institutions, such as the employment agency and the labour inspectorate, by implementing and improving the effectiveness of active labour market measures and fostering the dialogue with the civil society. The PEP falls short of justifying the

appropriateness of specific measures by e.g. referring to the results of evaluations of recent labour market policies.

Besides enumerating a number of planned measures and intended projects, the programme's objectives do not seem very ambitious. The PEP recalls the target of an employment rate of 55% by 2015 (as mentioned in the National Employment Strategy) and expects unemployment to drop by one percentage point annually, from 30.8% in 2011 to 27% in 2014. In the long-term scenario, the pace of the decline in unemployment is even lower, at about ¼ percentage point per year in the period 2050-2060. It would have been worth assessing the impact of an increasing employment rate on the unemployment rate. Overall, the moderate pace of the decline in the unemployment rate is rather surprising, in particular when taking into account the high level of unemployment in the country, the expected rather strong economic growth, the high priority which the government claims to devote to this issue and the mentioned measures in order to reduce unemployment.

Other reform areas

The PEP also presents a number of other reforms, which are considered to be important, such as public administration reform, agricultural reform and reform efforts in the field of education, environment, infrastructure, energy and transport, trade liberalisation etc.

There are frequent references to the EU accession requirements and adoption of the acquis. However, like in other areas, the presentation would have benefitted from better defining the conceptual framework behind those reform measures. Furthermore, it would have been useful to provide more operational information on planned reform measures, for example in the area of public administration reform or plans related to the agricultural sector, which seems to be a crucial priority sector for the government.

4.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The programme presents a summary of past economic developments, but compared to last year's submission, the provided data is less complete. The macroeconomic framework suffers from the lack of precise annual growth estimates and therefore remains ambiguous, providing a rather weak base for supporting the discussion of the fiscal framework. The PEP does not provide an in-depth assessment of the external sustainability and of competitiveness issues, as requested by the Commission.

Fiscal framework

The fiscal framework is broadly linked to the macroeconomic framework. However, the presentation mainly focuses on past developments and the 2012 budget with only very little information about the fiscal strategy beyond 2012. The document contains references to accession related challenges, but remains rather unspecific with respect to concrete policy measures envisaged. It would have benefitted from providing more concrete background information on the main reasons behind the dynamics of revenue and spending categories. The data are not in line with ESA 95 and there is no indication of a timeframe for better aligning fiscal statistics with ESA 95 standards. The authorities did not submit the fiscal notification this year.

Structural reforms

The document does not explicitly elaborate on structural obstacles to growth, as requested by the Commission, but only refers to the challenges of reducing unemployment and increase growth. The structural reform framework presents a wide array of intended policy objectives and measures in a broad range of areas. However, the presentation would have benefitted from being more explicit on the actual steps the authorities intend to undertake and on the economic results those measures are expected to achieve.

Compliance with required content, form and data

Weak alignment with ESA 95 continues to impede the analysis and comparability of the presented data, in particular in the area of public finances. With respect to content and the quality and quantity of provided information, the programme does not meet the level achieved last year.

* * *

Annex table: Structural indicators

Table II.2.6:

Annex: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 27				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
General economic background										
Real GDP [1]	6.1	5.0	-0.9	1.7	3.0f	3.2	0.3	-4.3	2.0	1.6f
Labour productivity [2]	56.7	58.5	60.1	58.3	n.a.	100	100	100	100	100
Real unit labour cost [3]	-12.9	2.6	9.9	-1.1	-0.3f	-0.8	1.0	2.8	-1.6	-0.5f
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	121.4	123.2	118.3	109.0	113.1
Inflation rate [5]	2.3	8.3	-0.8	1.6	3.9	2.3	3.7	1.0	2.1	3.1e
Unemployment rate [6]	34.9	33.8	32.2	32.0	30.5f	7.2	7.1	9.0	9.7	9.6
Employment										
Employment rate [7]	40.7	41.9	43.3	43.5	n.a.	65.3	65.8	64.5	64.1	n.a.
Employment rate - females [8]	32.3	32.9	33.5	34.0	n.a.	58.2	58.9	58.4	58.2	n.a.
Employment rate of older workers [9]	28.8	31.7	34.6	34.2	n.a.	44.6	45.6	46.0	46.3	n.a.
Long term unemployment [10]	30.1	28.7	26.3	26.7	n.a.	3.1	2.6	3.0	3.9	n.a.
Product market reforms										
Relative price levels [11]	44.6	46.3	45.4	44.5	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	61.6	63.6	n.a.	n.a.	n.a.	10.7	11.6	9.8	11.7	n.a.
Net FDI [13]	8.5	6.1	2.0	3.2	n.a.	3.9	2.2	2.1	1.0	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.6	0.6	0.6	n.a.
Business investment [16]	n.a.	n.a.	n.a.	n.a.	n.a.	18.7	18.4	16.2	15.9	n.a.
Knowledge based economy										
Tertiary graduates [17]	4.6	6.1	7.0	n.a.	n.a.	13.8	14.5	14.3	n.a.	n.a.
Spending on human resources [18]	n.a.	n.a.	n.a.	n.a.	n.a.	5.0	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	79.2	79.7	81.9	82.8	n.a.	78.1	78.5	78.6	79.0	n.a.
R&D expenditure [20]	n.a.	n.a.	n.a.	n.a.	n.a.	1.9	1.9	2.0	2.0	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	25.7	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Number of broadband access lines per 100 inhabitants.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources

5 MONTENEGRO

5.1 EXECUTIVE SUMMARY

Montenegro's first Pre-Accession Economic Programme (PEP 2012-2014) presents a comprehensive medium-term macroeconomic and fiscal framework based on the projection of a mild slowdown of growth in 2012 followed by a gradual acceleration in the outer years. The main objective is to strengthen fiscal and financial stability as a prerequisite for long term economic growth and higher employment. The document broadly complies with the Commission's requirements, notwithstanding some analytical gaps. Overall, the programme appears broadly consistent with earlier key policy documents and contributed to the preparation of the 2012 budget law.

The economy grew by 3% in 2011, slightly faster than estimated in the programme (2.5%). Growth was mainly driven by exports and private consumption, both supported by a resilient tourism industry. Inflation remained moderate, at 3% on average, reflecting higher food and transport prices as well as a rise of excises. Bank lending still remained negative. Despite some additional layoffs from heavy industry and mining, the labour market recorded some improvement thanks to the dynamism of the services sector. Employment levels increased by 1% in 2011 and the unemployment rate declined by 1.6 percentage points to 18%. The current account deficit (CAD) contracted to 19% of GDP in 2011 from 25% a year earlier, thanks to stronger exports and a surplus in the income account. In this context the country needs to reinforce the macroeconomic stability and to maintain the reform momentum as recommended in the latest progress report.

The macroeconomic scenario projects real GDP growth to accelerate to 4% in 2014, up from 2% in 2012. Over the period 2012-2014 private consumption is seen to be the main contributor to growth, supported by higher employment, rising wages and stronger credit growth. The impact of government consumption is expected to remain weak due to consolidation efforts, while investment growth will remain slightly negative on average. Given the uncertain international environment, the programme –as a useful complement– presents a low-growth scenario, based on lower average growth rates for FDI inflows, domestic credit, and exports. The projections' range resulting from these two macroeconomic scenarios seems broadly plausible. Yet, given the higher level of uncertainty resulting from the international environment, the probability of the low-growth scenario has significantly increased.

The programme fails to comply with the request of the Commission to provide and in-depth analysis on external sustainability and competitiveness issues. The current account deficit contracted from 30% of GDP in 2009 down to 19% in 2011 as a result of a crisis-led adjustment resulting in lower imports due to the contraction of domestic demand. The PEP foresees a further decline of external imbalances in the medium-term, albeit at a modest pace, as the trade deficit is expected to shrink by 2 percentage points of GDP until 2014. The PEP confirms the key role of FDI to ensure the financing of the external deficit. To some extent, the large external deficits also reflect a structural phenomenon representing high investments needs that would improve economic competitiveness and diversify the industrial base. However, the significant size of the external deficit exposes the country to refinancing risks and strong macroeconomic adjustments in case of slowing or reversing capital flows.

To achieve the sustainability of public finances the medium-term fiscal policy presents an expenditure-led consolidation, as the authorities remain committed to maintain the low tax rate policy in order to attract investments. So far, public spending has been reduced from 47% of GDP in 2010 down to 43% in 2011. The programme projects further consolidation of expenditures in the mid-term, targeting 38% of GDP by 2014. Meanwhile, revenues should remain constant at some 39% of GDP, to reach a balanced budget in 2013 and a net lending position in 2014. The fiscal space thus generated would serve to cut public debt and sustain public investments. However, the achievements of these budget targets appears increasingly unrealistic, given a deteriorating international environment, the contingent liabilities from state guarantees, and still rising tax arrears. Considering the large portion of non-discretionary spending in the budget, a decisive implementation of expenditure reforms will also be necessary to restrain fiscal deficits.

The PEP covers a broad range of structural reform areas in line with the programme's policy priorities. However, it does not provide an analysis of the main structural bottlenecks as requested by the Commission. Overall, there is a need for improving energy and transport infrastructures to lift potential growth. The restructuring of the metal industry and the continuation of privatisation are also necessary to improve industrial diversification, liberating resources, now spent on subsidies and state guarantees, and to rebalance metal manufacturing towards transport, energy and mineral ore exports. Tourism relies heavily on foreign investment inflows. Further efforts are still required to improve the business environment, notably to solve the issue of delays on project developments. Several measures presented in the programme relate to the continuation of previous initiatives (e.g. labour law, pensions reform, financial sector legislation, etc.), focusing on the development of secondary legislation.

Until its stabilisation in 2011, the financial sector presented the main risk for macroeconomic stability. At present, the most immediate threat remains the still weak capacity of the economy to refinance debt, risking a build-up of payment arrears due to the illiquidity of firms. A cutback in capital inflows, notably on green-field investments would depress domestic demand, delay the restructuring of the economy and infrastructure projects, but also weaken fiscal performance given the reliance of indirect tax revenue from imports. However, the main fiscal risk remains the cost of debt servicing, worsened by the need of additional borrowing for deficit financing and the activation of the substantial state guarantees extended to the aluminium plant.

Comparison of key macroeconomic and budgetary projections

		2010	2011	2012	2013	2014
Real GDP growth (% change)	COM	2.5	2.7	2.2	3.2	n.a.
	PEP 2012	**2.5**	**2.5**	**2.0**	**3.5**	**4.0**
Consumer price inflation (%)	COM	0.5	3.1	2.6	3.2	n.a.
	PEP 2012	**0.5**	**3.5**	**2.0**	**2.0**	**2.0**
General government balance (% of GDP)	COM	-4.9	-4.2	-2.6	-1.3	n.a.
	PEP 2012	**-4.9**	**-3.2**	**-1.1**	**0.1**	**1.0**
Primary balance (% of GDP)	COM	-1.9	-3.1	-1.4	0.1	n.a.
	PEP 2012	**-3.9**	**-1.8**	**0.7**	**1.9**	**2.8**
Government gross debt (% of GDP)	COM	42.9	44.0	44.4	42.8	n.a.
	PEP 2012	**40.9**	**43.8**	**46.9**	**45.4**	**42.9**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission autumn 2011 forecast.

5.2 INTRODUCTION [15]

Having participated during the past five years in the EU economic and fiscal surveillance process with the submission of Economic and Fiscal Programmes (EFP), Montenegro presented this year, for the first time, a Pre-Accession Economic Programme (PEP). The programme, which covers the period 2012-2014, was submitted on 30 January 2012 following its adoption by the government on 12 January.

The PEP has taken over naturally the role of the former EFP as a policy coordination instrument and has contributed to the preparation of the main national fiscal documents, notably the preparation of the 2012 Budget Law as well as the Economic Policy Guidelines for 2012, although there is no an explicit reference in the programme itself. The objectives of the programme are in line with the accession priorities; i.e. the need to reinforce macroeconomic stability and to maintain the reform momentum.

5.3 KEY CHALLENGES

The key policy challenges Montenegro is presently facing are the development of a competitive economy enabling sustainable and long-term growth, while reducing significant external vulnerabilities. To this end, the programme's overarching policy priorities are continuing fiscal consolidation, restoring and maintaining financial stability and further improving the business environment. The programme acknowledges the risks related to the strong reliance of both the private and public sectors on foreign financing, worsened by an uncertain external environment, notably in the euro area. The improvement of the business climate is seen to help attract FDI leading to industrial diversification and enhancing export potential, a gradual narrowing of significant external imbalances, and boosting employment over the medium term. The tightening of credit conditions has led to a further downturn in lending activity, restraining the liquidity of domestic enterprises and consequently feeding-back into stricter lending conditions of banks. On the fiscal side, besides effectively implementing measures to rein in public spending with a view to bring down the public debt ratio, a particular challenge will be to tackle growing tax arrears which have been undermining fiscal consolidation efforts. These issues are particularly striking in the case of a few troubled industrial companies, which if falling into bankruptcy would not only turn payment arrears into public revenues losses but would also disorderly activate state guarantees, adding further stress to public finances.

5.4 RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

5.4.1 Recent macroeconomic developments

In 2010, the economy recorded positive growth of 2.5%, which was significantly higher than last year's EFP estimate of 0.5%.The main factors behind the stronger growth were

[15] The ECOFIN Council of 26/27 November 2000 invited the Commission to *"report each year to the Council (Ecofin) on its assessment of the Pre-accession Economic Programmes*". The Council Presidency conclusions adopted last year can be found at: http://register.consilium.europa.eu/pdf/en/11/st09/st09654-re01.en11.pdf

higher net exports thanks to the expansion of the metal industry and a resilient tourism sector. The economy continued to recover in 2011 and real GDP grew by an estimated 3%, slightly above the PEP projection of 2.5%. The recovery was primarily driven by domestic demand, which recorded a positive growth for the first time after the crisis, whereas the contribution of net exports to growth dropped significantly. Preliminary data indicate that retail sales increased at constant prices by 15%, reflecting strong demand from tourism, feeding into private consumption. Nonetheless, domestic demand still remained constrained as bank lending further contracted, investments slowed down, employment growth remained limited, and net wages rose only marginally. On the supply side, manufacturing and mining output accelerated by some 6.5% in 2011 and the construction sector expanded by 11%, whereas the output of utilities contracted sharply over the year (33%). Consumer prices averaged 3% in 2011, driven by food and transport prices as well as higher excises on alcoholic beverages and tobacco. The current account deficit (CAD) continued narrowing, reaching 19% of GDP in 2011 compared to 25% a year earlier, and to the PEP's estimate of 23%. Net FDI contracted in 2011 by 28% year-on-year to some 12% of GDP.

5.4.2 Medium-term macroeconomic scenario

The macroeconomic scenario foresees the continuation of the recovery initiated in 2010. Following a deceleration of growth in 2012 resulting from a worsening external environment, growth is expected to reaccelerate in the outer years. However, given the uncertainty of international markets, the programme also presents a low-growth alternative scenario, where FDI inflows, credit activity, and exports growth would be much weaker in 2012 before recovering in the last two years. The projections' range resulting from these two macroeconomic scenarios seems broadly plausible. Yet, given the higher level of uncertainty resulting from recent international and domestic developments, the PEP acknowledges that the probability of the low-growth scenario has significantly increased. In the absence of a proper monetary policy, the fulfilment of the macroeconomic scenario relies on the accomplishment of the programme's fiscal and structural objectives.

Comparison of macroeconomic developments and forecasts

	2010		2011		2012		2013		2014	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	2.5	**2.5**	2.7	**2.5**	2.2	**2.0**	3.2	**3.5**	n.a.	**4.0**
Contributions:										
- Final domestic demand	-3.4	**-3.4**	-1.6	**2.4**	2.4	**1.5**	4.2	**3.6**	n.a.	**3.6**
- Change in inventories	1.4	**1.4**	0.2	**-1.7**	-0.7	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	4.5	**4.5**	4.1	**1.7**	0.5	**0.5**	-1.0	**-0.1**	n.a.	**0.4**
Employment (% change)	-1.9	**-1.9**	0.9	**-3.4**	0.9	**1.4**	1.7	**2.4**	n.a.	**2.4**
Unemployment rate (%)	19.7	**19.7**	19.2	**19.5**	19.0	**18.5**	18.6	**16.8**	n.a.	**14.9**
GDP deflator (% change)	1.6	**1.6**	4.5	**3.0**	5.3	**2.0**	5.9	**2.0**	n.a.	**2.0**
CPI inflation (%)	0.5	**0.5**	3.1	**3.5**	2.6	**2.0**	3.2	**2.0**	n.a.	**2.0**
Current account balance (% of GDP)	-24.6	**-24.6**	-21.5	**-22.8**	-20.4	**-21.7**	-21.3	**-20.8**	n.a.	**-19.7**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission Autumn 2011 Forecasts (COM)

Real sector

The PEP projects a moderate deceleration of the economy in 2012 caused by the worsening of the international environment, followed by stronger growth in 2013-2014. Real GDP growth is projected to reach 2% in 2012 and to accelerate to 3.5% in 2013 and 4% in 2014. The growth path is basically a reflection of private consumption trends, driven by the recovery of credit activity, as well as wage and employment growth. The contribution from government consumption is expected to be marginal (nought in 2002 and half a percentage point of GDP growth in 2013-2014), reflecting fiscal consolidation efforts. The contribution of exports will rely on tourism and agriculture rather than on the recovery of metal industry as it was the case in 2010 and 2011. Although the programme provides a list of shovel-ready energy and tourism projects, GFCF contribution to growth is balanced by the strong dependence of investments on imports of capital goods and equipment.

The programme provides a detailed estimate of GDP by activity sector, confirming the increasing participation of agriculture and tourism, with trade, hotels and restaurants, as well as transport, adding each one half a percentage points to GDP growth by 2014. Traditional industries (such as mining, metallurgy and utilities) are expected to maintain their annual growth contribution at 0.1 percentage point. Although the programme provides detailed information on recent labour and wages developments, it remains quite vague when it comes to mid-term projections. However, according to supplemental information submitted later on, employment is set to grow by 1.4% in 2012 and 2.4% in the following years, while unemployment will decline from 18.5% in 2012 to 14.9% in 2014. Labour productivity per worker will increase from 0.6% in 2012 to 1.5% in 2014 as GDP outpaces employment growth rates, gradually improving competitiveness.

The PEP provides an alternative low-growth macroeconomic scenario with a lower, albeit still positive, medium-term growth path assuming 0.5% GDP growth in 2012, which accelerates to 3.5% by 2014. The downward revision of growth affects all expenditure components; with the exception of exports and government consumption, which grow more strongly in 2014 compared to the baseline scenario. Wages and employment are expected to grow at a slower pace, dampening private consumption, although there are no concrete estimations on labour market developments in the low-growth scenario. On the supply side, the programme assumes reduced economic activity but does not provide quantitative estimates. Overall, although the baseline scenario is more elaborated, the volatile international environment and some contingent domestic industrial risks strongly support the usefulness of having simulated a less favourable outlook.

Inflation

The baseline projects annual average inflation to stay constant at 2% each year in the period 2012-2014, which lacks plausibility. The slowing down of average inflation, as compared to 2011 (3.1%), is based on the assumption that prices of imported energy and food - the recent two main drivers of inflation- will not rise above their current levels due to the deterioration in the European and global environment. Both scenarios identify a hike of electricity prices as the main risk given the significant dependency on energy imports. The low-growth scenario projects lower average inflation rates for 2012 and 2013, at 1.5% and 1.8% respectively. A more detailed analysis relating to domestic

demand, employment and disposable income of households and their respective impact on domestic prices would have been useful.

Monetary and exchange rate policy

Unilateral euroisation implies that there is only limited scope for the use of a proper monetary policy. The central bank is not an issuing bank, and most of its executive functions are related to banking supervision. It also engages in liquidity management operations in favour of the banking sector and issues treasury bills on behalf of the government. The structural reforms chapter briefly presents the initiatives already taken to strengthen the central bank capacity and supervisory function and some of the planned measures, including the adoption of international accounting standards.

External sector

The programme fails to comply with the request of the Commission to analyse external sustainability and competitiveness issues, focusing the external sector analysis on developments of the balance of payments. The current account deficit contracted from 30% of GDP in 2009 down to 19% in 2011. This was the result of a crisis-led adjustment and mainly due to lower imports following the contraction of domestic demand and credit, but also due to the resilience of the tourism industry and the recovery of merchandise exports. The extremely large headline current account deficit is financed primarily by large FDI (12% of GDP) and tourism receipts; part of the latter recorded in the errors and omissions surpluses, and equivalent to half the size of the CAD. The PEP foresees a further decline of external imbalances in the medium-term, albeit at a modest pace, driven by faster growth of exports than imports. As a result, the trade deficit is expected to shrink between 2012 and 2014 by 2 percentage points of GDP. Meanwhile, income and transfers balances would remain in surplus at some 3% of GDP. According to the programme, lower FDI would be the main factor for the external rebalancing. Given the strong positive correlation between imports and investments (see graph below), the contraction of investments would result in lower imports and thus reduce the trade deficit. However, according to historical data, other factors like bank credit have a stronger effect on imports than FDI.

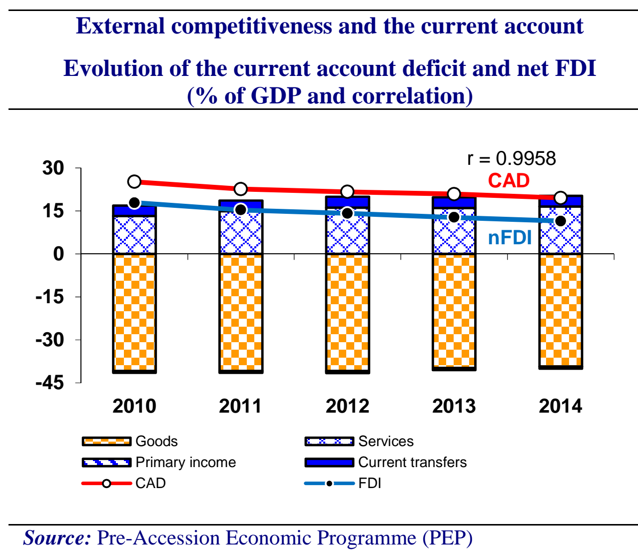
The significant size of current account deficits exposes the country to refinancing risks and strong macroeconomic adjustments in case of slowing or reversing capital flows. Such a scenario could be triggered, for instance, by a sharp decline in FDI resulting from the eurozone's macroeconomic deterioration, or by restricted access to external financing of the main external debtors16 to refinance their maturing external obligations. To some extent, the large external deficits also reflect a structural phenomenon representing high investments needs that would improve economic competitiveness, diversify the industrial base, and raise future productive capacity of the economy. The PEP confirms the key role of FDI to ensure the financing of the external deficit. The low-growth scenario estimates a very mild contraction of FDI by 0.6 percentage points in 2012, and 0.2 and 0.8 in the next two years compared to the baseline scenario, resulting in similar effect for the CAD,

[16] The main external debtors are the nine foreign-owned banks, the aluminium factory and the electric power company EPCG.

thus not adequately reflecting the potential risks resulting from a significant deterioration of the external environment.

External competitiveness and the current account

Evolution of the current account deficit and net FDI (% of GDP and correlation)



Source: Pre-Accession Economic Programme (PEP)

The continuous contraction of bank lending to the private sector since the outbreak of the global financial crisis has contributed to the stabilisation of until then fast-rising private external debt. Data on nonfinancial private sector external debt is not available. Some estimates suggest total external debt to be close to 100% of GDP in 2011, of which the public external debt accounts for one third. The programme does not provide an estimate on the external debt nor on the net international investment position (NIIP) which should have been considered given the very high external indebtedness of the economy and the risk it represents.

Financial sector

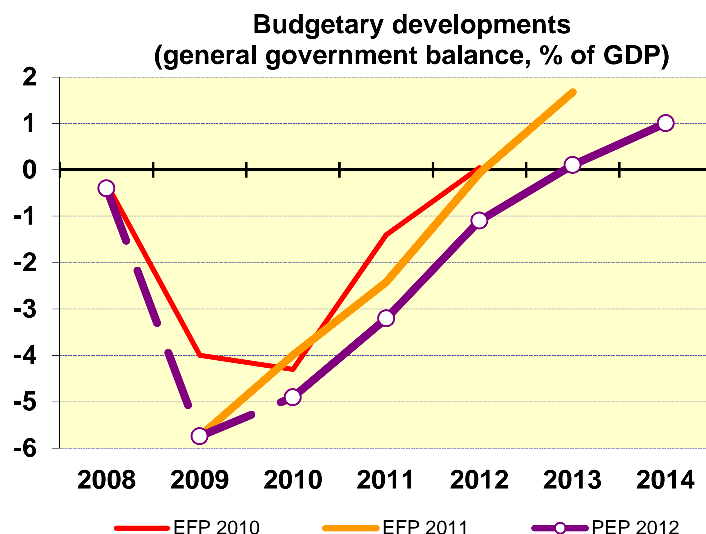
The banking sector was severely affected by the global financial crisis and until recently presented one of the major risks for the macroeconomic stability of the country. The decisive support from foreign parent banks, recapitalising domestic subsidiaries and repatriating bad assets, as well as the timely implemented strengthening of bank regulations and supervision probably prevented a major crisis. The sector somewhat stabilised in 2011, notably after the mid-year reversal of until then continuously worsening of non-performing loans (NPLs), which nevertheless still accounted for 15% of total loans by the end of 2011. The reduction during the second half of 2011 of NPLs resulted in a contraction of provision expenses, reducing the aggregated loss of the banking sector to EUR 3 million at the end of 2011, compared to EUR 82 million losses a year earlier. After three years of continuous contraction, the programme expects bank lending to grow by 5% year-on-year in 2012 and to accelerate to 8.4% by the end of 2014. The main risk identified by the PEP stems from the high level of indebtedness of the real sector, worsened by tight credit conditions. The low growth scenario evaluates also the risk from the exposure to the euro area sovereign debt crisis and a weakening economic outlook, resulting in a lower credit growth rate of 1.7% in 2012, which however accelerates to similar levels as the baseline in 2014.

Main risks to the macroeconomic scenario

The programme presents various risks originating from a recession in partner countries which would affect exports, tourism, FDI, and employment. A cutback in capital inflows, notably on greenfield investments, also represents a major risk as it would depress domestic demand, but also further weaken fiscal performance given the reliance of indirect tax revenue from imports. However, until very recently the stability of the financial sector presented the main reason of concern for the overall macroeconomic stability. As the banking sector gradually stabilises, the currently most immediate threat remains the still weak capacity of the economy to refinance debt, risking a build-up of payment arrears, especially in case of further deterioration of the international economic environment. The aluminium factory represents a particular case on its own. The largest exporter of the country is producing at a loss and is highly indebted.

5.5 PUBLIC FINANCE

To achieve the sustainability of public finances, the medium-term fiscal policy presents an expenditure-led consolidation which foresees a reduction of the spending ratio by 4.6 percentage points, progressively reducing the level of total public expenditures to 38% of GDP by 2014. Meanwhile, revenues should remain broadly constant at some 39% of GDP. The envisaged fiscal targets (identified in the programme as fiscal anchors) foresee reaching a balanced budget in 2013, and a fiscal surplus to 2014, while capital spending remains in the mid-term broadly constant at some 3% of GDP. The authorities are committed to maintain their low tax rate policy in order to attract investments. Given that 80% of total public spending is non-discretionary, the fiscal strategy relies on the effective implementation of the structural reforms agenda, and notably the reform of pensions, the labour market and public sector restructuring. The projected medium-term net lending position should help to reduce public debt levels, from a peak of 47% of GDP in 2012 down to 43% by end of 2014. The PEP foresees significantly lower levels of revenue for the period 2011-2013, compared to last year's programme projections of 42% of GDP. Expenditures have also been revised downwards, although more moderately (one percentage point of GDP lower per year). Therefore, the objective of reaching a balanced budget is postponed by one year to 2013. The programme presents more detailed analyses than in previous exercises, notably on the reform of the pension system. However, there is still room for further improvement; like providing further details on the concrete measures to support the reduction of the spending ratio in each year, or analysing the structural components of public expenditures too.



5.5.1 Budget implementation in 2011

The general government budget was reduced from 47% of GDP in 2010 down to 43% in 2011 resulting in a consolidated budget deficit of 4% of GDP in 2011, almost twice above the original plan. Consolidated revenues totalled 39% of GDP in 2011, marginally lower than the PEP estimation, and in contrast with a level of 42% a year earlier. Overall, tax income remained broadly stable over the year, recording some 24% of GDP. The corporate income tax and value added tax were two positive exceptions, recording some moderate growth over the year. However, social security contributions deteriorated, driven by lower health and pension contributions. Consolidation efforts brought current expenditures below 40% of GDP compared to 42.5% the year before. Further cuts took place on other personal income, supplies and services, as well as on regular maintenance and capital expenditure. However, two major expenditure lines recorded significant expansion compared to last year: Gross salaries sharply increased by EUR 78 million (or 2.4% of GDP) as a result of the reclassification of health sector workers wages from 'transfers' into 'gross salaries'. In addition, pensions expanded by almost 8% due to the adjustment of military pensions, but also due to a higher than expected increase of the number of beneficiaries from restructured industries. Capital spending also registered cuts for additional 1% of GDP.

General government net borrowing missed the original budget target by 1.7% of GDP in 2011. The revenue side appears to account for most of the shortfall. Proceeds from the corporate income tax and local taxes recorded a better outcome than expected, the latter contributing to the small surplus of the local government budget. However, VAT, real estate taxes, excises and social security contributions underperformed against the plan. On the expenditure side of the budget, the annual increase of gross wages was one percentage point lower when compared to the original design, despite the substantial re-allocation of transfers related to health workers. By contrast, the 4% increase of pensions above the original budget plan suggests some slippage on this item. Once more, capital expenditures served as fiscal buffer, with unplanned cuts of almost 18%. Overall, when considering a deteriorating international environment, contingent liabilities from state guarantees as well as tax arrears (which increased by 0.5% of GDP in 2011), it seems

unlikely that the primary balance, as foreseen in the programme, may become positive as of next year.

5.5.2 Near-term and medium-term budget strategy

The parliament adopted on 22 December 2011 the budget law for 2012, envisaging a fiscal deficit of -1.25% of GDP in 2012, compared to -1.05% foreseen in the PEP. The authorities expect real GDP growth of 2%. One of the main objectives is to continue the consolidation of public finances, bringing the level of public expenditures close to 40% of GDP. However, the budget also plans further rise of pensions, social benefits, and interest payments, to be partially balanced by a 25% reduction on discretionary spending, subsidies, as well as travel and representation costs.

The implementation of the 2012 budget appears like a major challenge given the poor outcome of the previous year. Total revenues should remain flat at 39% of GDP, assuming that tax revenue will remain in line with the pace of expansion of the economy, while non-tax revenues are expected to grow according to inflation rates. Public spending should further contract by 2.5 percentage points of GDP in 2012 compared to 2011. One of the main fiscal measures consists on the freezing of public sector wages in real terms. Pensions and social benefit spending should increase by additional 0.7% of GDP as a consequence of industrial and public sector restructuring. In 2012 the second and final phase of the accounting reclassification of health workers salaries from transfers into gross wages should be completed. Capital expenditure will be marginally reduced by 0.3 percentage point of GDP.

At first sight, the 2012 budget is an attempt to continue further consolidation. However, the deficit target of 1% of GDP seems at present unrealistic when considering the weakness of fiscal revenues performance against the plan, and the banks call in early 2012 of the state guarantees extended to the aluminium plant. In response, the Montenegrin authorities prepared in April a budget rebalancing with additional revenue and expenditure measures adding around one percentage point of GDP above the original 2012 budget measures. On the one hand, more than 80% of total spending is non-discretionary and their reduction mainly depends on the effective implementation of structural reforms, like the recent amendments to the pension or labour laws. However, the full impact of these reforms will not be immediate. On the other hand, the programme confirms the authorities' fiscal stance to maintain the current low tax rates in order to attract investors. Overall, the Commission forecast estimates a higher deficit of some 2.6% of GDP, resulting from tax arrears and the servicing of state guarantees, which the programme presents only as a potential risks.

Box: The budget for 2012

* The draft budget for 2012 was presented to the State Audit Institution and to the parliamentary Committee for Economy, Finance and Budget in the first week of December 2011, and finally adopted by the Assembly on 22 December.
* The target for the general government balance in 2012 is a consolidated deficit of -1.25% of GDP, compared to -1.05 foreseen in the PEP.
* The main fiscal measures include an increase of excise duties on tobacco, alcohol, as well as new

excises on coffee and carbonated drinks. Public sector wages should remain broadly constant, at 21.2% of GDP like in 2011. Other measures, like tax exemptions for personal and corporate income taxes for underdeveloped municipalities, or the adoption of a higher base for social security contributions are not presented in the PEP.

* Industry restructuring will also have an impact on the budget, resulting in new pensions and social transfers for redundant workers. However, the PEP does not include some 1% of GDP of costs deriving from the servicing of state guarantees of the aluminium plant.

* Finally, the PEP foresees a marginal loss in revenues from the decision in 2011 to remove some minor administrative and custom fees in order to eliminate business barriers.

Table: Main measures in the budget for 2012

Revenue measures*	**Expenditure measures****
• Amendments to the Law on Excise Duties (+0.4% of GDP) • Tax exemptions (PIT, CIT) for underdeveloped municipalities (N/A) • Higher base for social security insurance (N/A) • Amendment to the law on administrative fees (-0.03% of GDP)	• Contention of public sector wages • Reduction of current spending (goods and services) (-1% of GDP) • Increase of pensions and social transfers to former workers of restructured industries and public sector (+0.7% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Sources: PEP 2012

The baseline scenario applies a cautious approach, foreseeing a constant share of revenues at 39% of GDP for the outer years (2013-2014), notwithstanding an expected acceleration of growth. On the contrary, consolidated public expenditures are expected to further decline to 39% of GDP in 2013 and 38% in 2014. However, the projections for 2013 and 2014 lack a comprehensive description of underlying fiscal measures to support the reduction of the spending ratio in each year. The PEP also presents a low-growth fiscal scenario, where public spending would increase as a percentage of GDP compared to the baseline scenario, due in part to higher social security payments as automatic stabilisers play during the downturn, but also the political decision not to adjust further the level of expenditures to lower revenues. This fiscal stance in the low-growth scenario would result in a deficit close to 2% of GDP in 2014, compared to a 1% surplus in the baseline. On this scenario the PEP considers the possibility of adjusting fiscal policy in response to adverse developments, by introducing new taxes or raising their rates, but without detailing which ones and their expected impact on the budget.

The programme identifies several risks related to the uncertain international environment. In addition to negative impact on commodity exports, FDI and tourism, an externally driven credit squeeze could also result in rising tax arrears. On the domestic side, the risk of liquidation of the aluminium plant would bring a temporary contraction of GDP and employment. Yet, the servicing of state guarantees would have an overall impact on public debt of some 6% of GDP, adding pressure on external refinancing needs. Furthermore, the programme insists on the reliance of domestic growth on uncertain FDI inflows, and their impact on fiscal revenues. In order to reduce the risk of public wages slippage under social pressure, the government and the trade unions signed end-2011 an agreement on wage policy valid until 2015. It presents a first attempt to link salaries to productivity, rising public workers' wages only in case that the economy expands by

more than 3.5% or annual average inflation exceeds 2%. However, in case GDP contracts by more than 2%, the social partners will negotiate a cut in public sector salaries

Composition of the budgetary adjustment (% of GDP)

	2010	2011	2012	2013	2014	Change: 2011-14
Revenues	42.3	39.4	39.4	39.2	39.0	-0.4
- Taxes and social security contributions	34.5	33.6	34.2	34.2	34.2	0.6
- Other (residual)	7.8	5.8	5.2	5.0	4.8	-1.0
Expenditure	47.2	42.6	40.5	39.1	38.0	-4.6
- Primary expenditure	46.2	41.2	38.7	37.3	36.2	-5.0
of which:						
Gross fixed capital formation	4.7	3.4	3.1	3.1	3.1	-0.3
Consumption	0.0	0.0	0.0	0.0	0.0	0.0
Transfers & subsidies	14.9	15.4	14.6	14.4	14.2	-1.2
Other (residual)	26.6	22.4	21.0	19.8	18.9	-3.5
- Interest payments	1.0	1.4	1.8	1.8	1.8	0.4
Budget balance	-4.9	-3.2	-1.1	0.1	1.0	4.2
- Cyclically adjusted	-6.4	-2.4	-0.6	0.5	1.4	3.8
Primary balance	-3.9	-1.8	0.7	1.9	2.8	4.6
Gross debt level	40.9	43.8	46.9	45.4	42.9	-0.9

Sources: Pre-Accession Economic Programme (PEP) 2012, ECFIN calculations

Structural balance (cyclical component of deficit, one-off measures and temporary measures, fiscal stance)

The programme presents a first attempt to calculate structural balances, albeit focussing on the revenue side only. The analysis could be further extended to the expenditure side of the budget in next exercises. According to this preliminary analysis, Montenegro tax revenues present a highly pro-cyclical pattern. During boom periods revenues are far higher than potential structural outcome, resulting in strong budget surpluses. The PEP runs three different estimates for direct, indirect and other taxes. A simple regression on GDP is applied in all three cases, with direct taxes (CIT, PIT, excises) corrected for past changes of tax rates occurred in 2009 and 2010, and indirect taxes (VAT, excises and custom duties) adjusted for imports trends. The analysis shows that, mainly due to tax arrears, revenues are significantly lower in the lower growth part of the economic cycle. The cyclically adjusted revenues suggest marginal net lending positions once GDP reaches growth rates of 3.5% (considering the estimated annual potential growth rate at 3.2%). However, given the lack of longer and more consistent time-series and the absence of estimates of the structural expenditure side, these results should be considered with caution.

Budgetary implications of "major structural reforms"

The reforms agenda is to a large extent a continuation of past measures, their focus shifting from the design phase to implementation and development. The PEP's efforts to gauge the fiscal impact of these reforms are to some extent more complete that previous year's EFP. However, the evaluation of the impact is still basically focused on the budgetary cost of the measures rather than their net impact, with the exception of labour

market, pension system, transport, and environment reforms. On the expenditure side, the pension reform is one of the most important given the influence of the social security balance on the deficit, and should contribute to enhancing fiscal sustainability by increasing retirement age, changing the indexation formula and strengthening the incentives against early retirement. Eradicating subsidies to the aluminium and steel companies will be difficult without a successful restructuring of these companies that increase their profitability. The reform of the public sector, merging several agencies and common services, should alleviate the costs of the public sector while improving public administration could improve expenditure allocation and management in the medium term. Once efficiency gains are exhausted on the expenditure side, either further cuts in public sector or some structural changes in revenues (i.e. hiking some tax rates) might be needed to ensure fiscal sustainability. On the revenue side, the programme only foresees the increase of some excise duties in 2012, which should raise total revenues by additional 0.4% of GDP. Yet, fiscal revenues could also improve in the case of successful privatisations of some large companies. Meanwhile, the labour and pension reforms should also provide additional fiscal revenues from a higher number of workers as a result of the new laws.

General government debt

Montenegro's public debt has been increasing since the outbreak of the global financial crisis in 2008, when it had been at levels below 30% of GDP. The rapid acceleration of the debt stock since then has been mainly driven by deficit financing needs. Most of the deficit has been financed by external borrowing, with the exception of local governments which ensure financing through domestic borrowing. According to the programme, total public debt will reach a peak at 47% of GDP in 2012, driven by a surge in the stock-flow of foreign debt to finance the budget gap. Public debt should decline gradually afterwards in the wake of consolidation efforts on public expenditures and subsequent primary balance surpluses. Although the external debt also reflects the financing of major infrastructure projects, mostly through loans from international financial institutions, these represent a small part of the net stock-flow compared to borrowing for budget financing. Meanwhile, domestic debt (of which 43% relate to legacy issues of restitution and frozen foreign currency savings) is set to decline, from 10% of GDP in 2010 down to 7.3% in 2014.

Out of total issued guarantees, amounting to 12% of GDP, the state guarantees extended in favour of the aluminium factory (KAP) represent the most immediate risk, and represent some 5% of GDP including interest. The factory has already failed servicing some loan instalments due to liquidity problems. The decision of the government in early 2012 to take over the ownership of the aluminium plant should facilitate servicing this debt as scheduled instead of being called-in at once. However, the payment of the state guarantees stock risks to be ineffective if KAP continues running daily losses in the meantime. Another risk identified in the low-growth scenario would be a further deepening of the economic crisis, driving public debt close to 50% of GDP in 2013, although set to decline afterwards. Yet, even in the worst-case scenario, the sustainability of the public debt does not raise immediate concerns, although risks prevail. The debt stock's currency composition and maturity structure remain relatively favourable. Euro-denominated debt accounts for some 92% of total public debt, while debt denominated in US dollars and Swiss francs represent 2% of total debt each. The public debt remains primarily on concessional terms, with average interest rates at about 3.9% and maturity

of 6.7 years. The structure of credit also has long repayment and grace periods of up to 10 years.

Composition of changes in the debt ratio (% of GDP)

	2010	2011*	2012	2013	2014
Gross debt ratio [1]	**40.9**	**43.8**	**46.9**	**45.4**	**42.9**
Change in the ratio	2.7	2.9	3.1	-1.6	-2.4
Contributions [2]:					
1. Primary balance	**-3.9**	**-1.9**	**0.7**	**1.9**	**2.8**
2. "Snow-ball" effect	**-0.5**	**-0.7**	**0.1**	**-0.7**	**-0.8**
Of which:					
Interest expenditure	1.0	1.4	1.8	1.8	1.8
Growth effect	-0.9	-1.0	-0.8	-1.6	-1.7
Inflation effect	-0.6	-1.1	-0.8	-0.9	-0.9
3. Stock-flow	**-0.7**	**1.7**	**3.7**	**1.0**	**1.2**

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator).

* PEP data corresponds to debt stock until September 2011.

Source: Pre-Accession Economic Programme (PEP) 2012, ECFIN calculations

Debt management focuses on securing financing from external sources to refinance the general government budget; on enforcing the more transparent and detailed set of rules adopted in May 2011 which defines more precisely the guidelines for local governments borrowing; and on carrying out a stricter control on future government guarantees, limiting these to infrastructure or added-value projects. The amended fiscal framework will deepen fiscal consolidation, move towards fiscal surpluses and reverse the debt dynamics, setting the public debt on a downward trajectory.

5.5.3 Sensitivity analysis and comparison with previous PEP

The present PEP is based on lower than expected GDP growth and a reduction in current revenues compared to last year's programme. Therefore, budget rebalancing has been postponed by one year compared to the EFP projections. The sensitivity analysis is presented as the low-growth scenarios, and the programme identifies the main fiscal risks and fall-back positions which however remain rather vague. The main concern is the cost of debt servicing, worsened by additional borrowing for deficit financing. The baseline foresees that fiscal consolidation will lead to a balanced budget and thus to put an end to these borrowing requirements as of 2015. Other fiscal risks are related to the accumulation of tax arrears, the rigidity of the budget structure, contingent state guarantees, and the current difficulties to access capital markets at reasonable cost. To mitigate such risks, the government intends, amongst others, to rationalise the number of employees, to reschedule state guarantees, and to secure funds outside European capital markets, including the possibility of a precautionary arrangement with the IMF.

5.5.4 Quality of public finances and institutional features

The programme argues that as a result of past tax reforms the level of revenue collection in terms of GDP as well as per capita is higher than in the majority of regional peers. In

order to attract investment, the revenue side of the Montenegrin budget is characterised by low tax rates. The programme does not envisage any major new tax measures except the increase of some excises and of the marginal top ceiling for social security contributions. Other measures, like the rescheduling of payments for some corporate taxes, can be considered more as measures to ease liquidity constraints of companies rather than a proper tax reform on itself. On the expenditure side, the main objective is to reduce current spending levels in order to preserve sufficient fiscal space for increasing future capital investments, though the programme is lacking details on the concrete measures to rationalise spending. Cuts in current expenditures have been made in recent years, but further reduction may not come as easily. The programme does not foresee capital investment to drop below 3% of GDP. In order to ensure the prioritization of investments, the medium-term budget framework includes in the 2012 budget a detailed evaluation of policy priorities of spending units.

As in previous programmes, the PEP presents its projections on deficit, current and capital spending as well as on public debt as fiscal anchors. However, the objective set for capital spending is higher than the one presented in the fiscal scenario. Moreover, these objectives are not supplemented by any corrective legal measure in case of deviation. So far, institutional improvement in public finances concern the harmonisation of tax and custom legislation with the EU Acquis, or the reinforcement of administrative capacities to deal with future EU funds for agriculture, regional and human development. The Ministry of Finance has also reorganised one department to deal with public revenues projections separately from expenditures. Further improvements and alignments of accounting and auditing standards have been planned for 2012. In March 2012 the government adopted the IMF General Data Dissemination System (GDDS).

5.5.5 Sustainability of public finances

The programme contains an analysis of the long-term sustainability of public finance by comparing estimated effects of the 2010 law on pension reform to an estimated no policy change scenario. Assuming constant productivity and unemployment rates, the new law which rises compulsory years of service to 40 and the retirement age to 67, will start reducing the number of eligible beneficiaries as of 2011, decreasing the cost of pensions by 1% of GDP until 2013, when workers aged 65 in 2011 will reach 67. This reduction of pension costs will continue, although at a slower pace after 2013, until pensions expenditure would stabilise at around 9% of GDP by 2040. In addition, the former indexation formula was revised to a more favourable ratio for the public finances, with a higher weight on inflation than wages. In a no-policy-change scenario, pension costs would instead have kept increasing above 13% of GDP by 2050.

The programme also provides some information on the reforms of the education and health systems. In order to contain expenditure on education, efforts would focus on the reduction of the costs per student, although these measures are not well described. Other reports17 point to the need of rebalancing the number of schools and students. The reforms to improve efficiency in the public health system include the introduction of diagnosis-related payments according to average costs which are expected to reduce the

[17] More detailed information on pensions, education and public health reforms is available at the World Bank's Public Expenditure and Institutional Review report of 12 October 2011.

outlays of total primary healthcare by 14%. A new basic package for secondary and tertiary care will also be defined. The increase of excises on alcohol, tobacco and carbonated drinks mentioned earlier, is also considered to create long-term savings on treatment costs while contributing to public finances in the interim.

5.6 STRUCTURAL REFORMS

5.6.1 Obstacles to growth and the structural reform agenda

The programme does not identify and discuss the main structural obstacles to growth and the structural strategy and priorities envisaged to tackle them as requested by the Commission. There is a broad consensus in recognising the need for improvement in energy provision and infrastructure to support higher growth rates. Yet, the financing of such projects depends on an uncertain international environment, which could result in delays or external shocks to tourism or metal prices. The restructuring of the metal industry and the continuation of privatisation is also necessary to improve industrial diversification, freeing resources, now spent on subsidies and state guarantees. Potential for further investments still remains high, especially on tourism, which relies heavily on foreign investment inflows. However, further efforts are still required to improve the business environment, notably to avoid contradicting rules between local and central authorities which unnecessary delay project developments.

5.6.2 Key areas of structural reform

The PEP covers a broad range of structural reform areas, following up on last year's measures and consistent with the programme's policy priorities. The presentation of measures tends to be rather backward and future plans focused on the short term (2012). Several measures presented in the programme relate to the continuation of previous initiatives, like further development of secondary legislation following the adoption of several new laws in 2011, and the focus is on their implementation. The quality of the different sections varies markedly, although the various contributions are better coordinated than in last year's programme. Again, some additional efforts are required to estimate the budgetary effects for all reforms. The budget impact is very high, although it is far from accurate, as the impact of the reforms, especially on the budget revenues, is largely underestimated.

Net direct budgetary impact of key reform commitments (in EUR million)

	2012	2013	2014
Privatisation	18.0	18.0	18.0
Competition policy and state aid	-0.1	-0.4	-0.4
Business environment and Tax policy	11.5	n.a.	n.a.
Network industries	-8.0	n.a.	n.a.
Labour market	-14.7	-15.8	-16.3
Education and Research	-8.9	-7.1	-6.5
Pension system	-124.1	-107.5	-87.1
Healthcare system	-7.4	-9.4	-9.0
Social protection	-65.1	-67.8	-70.1
State administration	n.a.	n.a.	n.a.
Other measures	-110.6	-107.0	-102.7
Total impact on the budget	-309.3	-297.0	-274.0
Total impact on the budget (in % of GDP)	-9.1	-8.3	-7.2

Source: Economic and Fiscal Programme (PEP) 2012, ECFIN calculations

Product and capital markets

The privatisation process recorded little progress in 2011, opening successfully just two tenders for the sale of the state-owned newspaper and some property from one agro-company. The plans for 2012 lists thirteen companies for sale, whose total value is estimated at 247 million (or 7% of GDP), although given the uncertainty of investors' interest, its impact on budget revenues is not presented[18]. The list includes the railways, the airlines, the harbour's cargo terminal, the national post, as well as some smaller companies. Apart from the injection of funds into the budget, the motivation for their sale is rather to improve their competitiveness through new investments. The restructuration of the two large metal industries remains uncertain. The steel mill has been declared bankrupt and offered for sale, while the future of the aluminium industry remains unclear after the parliament decided in early 2012 to end the privatisation deal.

The business environment continued to improve during 2011 with the introduction of one-stop-shop for business registration, the adoption of new laws on bankruptcy, the enforcement and securing of claims and the simplification of building permits and procedures (administrative guillotine). Further activities are planned with respect to electronic company registration, continuing the simplification of procedures and developing a new legislation for building permits. However, while progress is being achieved at central government level, additional efforts are still needed by local governments. The overall situation of domestic banks seems to improve slightly, although credit tightening appears to remain one of the main obstacles for growth. While this situation seems difficult to alleviate until the situation of international financial markets improves too, the Investment Development Fund is broadening its range of activities in support of local businesses, for example by introducing export insurance and factoring.

[18] The budget medium-term framework foresees, however, annual revenues from privatisation of just half a percent of GDP per year until 2014.

The ongoing reform of the electricity market, heading for an improvement of the transmission network and new interconnections, resulted in some export diversification. Electricity represented the second largest export item in 2011, accounting for 11% of total commodity exports compared to nil two years earlier.

Labour market

The labour market has been characterised by its rigidity, namely within the heavy industry sectors, and the restrictive collective agreements, resulting in low wage flexibility, high unemployment and low activity rates among the old and young. To soften these rigidities the labour law was amended in December 2011. The new legislation addresses excessive employment protection by simplifying the procedure of individual dismissals. It also introduces temporary employment agencies. It also limits fixed-term contracts to no more than 24 months, while they had an unlimited duration before, being the primary vehicle for private sector job creation in recent years, presenting a dilemma between weakened labour market performance and the search of a sustainable long-term solution. Additional amendments were also implemented to the law on employment of foreigners, of disabled persons, as well as on recognition of foreign qualifications. These reforms are complemented by those implemented in education, with a focus on improving its quality, by adopting a system of external graduation and vocational exams at the end of high school. Another issue of the labour market is the lack of mobility and the substantial development gap between the North and the rest of the country. Overall, the employment policy remains fragmented, mostly consisting in isolated active labour market measures. However, the programme announces a reduction of these active measures in 2012, which raises concerns given the still high level of unemployment and skills mismatches.

Other reform areas

The chapter on structural reforms also describes many other reform areas, like public administration, agriculture, environment, financial sector, etc. The programme would generally benefit from establishing a closer link between the outlined reform measures and the achievement of core objectives of the programme. This would also require the setting up of a clear timeline and sequencing of reform implementation.

5.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The programme presents a rather clear and succinct picture of past economic developments and covers all relevant data available at the time of submission. The presentation of past economic developments has overall improved compared to last year’s programme. This year's PEP includes two scenarios: a relatively cautious baseline and a lower growth scenario. It offers a preliminary evaluation of the output gap, as well as a detailed projection of contributions to value added by economic sector. Furthermore, the quality and coverage of data has generally improved. For the first time estimates on labour market developments have been provided. However, additional efforts are still needed to complete the statistical annex, in particular the long-term sustainability of public finances. A shortcoming of the programme is the lack of an analysis of the, the sustainability of the external position, and of competitiveness issues, as explicitly requested by the Commission.

Fiscal framework

The fiscal programme is broadly consistent with the macroeconomic framework, and sufficiently comprehensive, with the key measures on the revenue and expenditure side well identified and articulated in the budget for 2012. However, the level of explanation is less detailed or inexistent as regards outer years. The analysis of the sustainability of the pension reforms presents a particular qualitative improvement compared to previous programmes. However, there is still room for further improvement of other sections, like the structural components of public expenditures. The programme does not include any reference to the Progress Reports; even if the outline encouraged the authorities to include cross-references to the Commission's assessment. Fiscal data is not in line with ESA 95 standards, although the programme announces a project with the Slovakian authorities to assist with this conversion. Montenegro did not present a fiscal notification in 2011. However, it is expected to fully participate in the next exercises.

Structural reforms

The programme does not present the main structural obstacles to growth or a summary introduction to the chapter, which could articulate the interaction of macroeconomic, fiscal and structural policies. The presentation starts directly with each reform section, presenting a backward looking introductory part followed by comments on planned activities largely focused on 2012. Still, the quality of the different sections varies significantly. Some additional efforts are required to estimate the budgetary effects for all reforms. For instance, there are no quantitative estimates in the area of state aid reform, although data on subsidies is available in the budget's medium-term framework.

* * *

Annex: Structural indicators

	Montenegro					EU 27				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
General economic background										
Real GDP [1]	10.6	6.9	-5.7	2.5	2.7f	3.2	0.3	-4.3	2.0	1.6f
Labour productivity [2]	29.1	37.0	34.2	37.1	37.7	100	100	100	100	100
Real unit labour cost [3]	15.0	7.0	-3.3	6.1	-3.3f	-0.8	1.0	2.8	-1.6	-0.5f
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	121.4	123.2	118.3	109.0	113.1
Inflation rate [5]	4.3	7.4	3.4	0.5	3.1	2.3	3.7	1.0	2.1	3.1e
Unemployment rate [6]	19.3	16.8	19.1	19.7	19.7	7.2	7.1	9.0	9.7	9.6
Employment										
Employment rate [7]	42.7	43.2	41.3	40.3	39.0	65.3	65.8	64.5	64.1	n.a.
Employment rate - females [8]	21.5	17.9	20.4	20.7	18.4	58.2	58.9	58.4	58.2	n.a.
Employment rate of older workers [9]	n.a.	3.0	2.3	1.8	n.a.	44.6	45.6	46.0	46.3	n.a.
Long term unemployment [10]	38.1	35.6	41.1	40.4	33.6	3.1	2.6	3.0	3.9	n.a.
Product market reforms										
Relative price levels [11]	55.7	60.3	61.4	59.3	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	97.2	97.8	65.9	65.4	69.0	10.7	11.6	9.8	11.7	n.a.
Net FDI [13]	21.2	18.9	35.8	17.5	11.9	3.9	2.2	2.1	1.0	n.a.
Sectoral and ad-hoc state aid [15]	0.5	0.7	1.7	1.3	1.4	0.5	0.6	0.6	0.6	n.a.
Business investment [16]	25.4	30.6	19.2	16.4	15.2f	18.7	18.4	16.2	15.9	n.a.
Knowledge based economy										
Tertiary graduates [17]	3.6	6.8	8.8	n.a.	n.a.	13.8	14.5	14.3	n.a.	n.a.
Spending on human resources [18]	4.3	4.7	4.5	4.5	n.a.	5.0	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	n.a.	n.a.	n.a.	n.a.	n.a.	78.1	78.5	78.6	79.0	n.a.
R&D expenditure [20]	n.a.	n.a.	n.a.	n.a.	n.a.	1.9	1.9	2.0	2.0	n.a.
Broadband penetration rate [21]	2.6	5.5	9.0	12.0	12.5	18.2	21.7	23.9	25.7	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM, Montenegro = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Number of broadband access lines per 100 inhabitants.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources

6 SERBIA

6.1 EXECUTIVE SUMMARY

Serbia submitted its Economic and Fiscal Programme covering the period 2012-2014 on 31 January 2011. The country's key medium-term challenge remains to ensure a stable macroeconomic and financial environment conducive to stronger growth, more jobs and an improvement of living standards. The economic recovery continued in 2011, with GDP growth of 1.6%, mainly fuelled by a pick-up in investment activity. However, in the second half of the year growth came under pressure due to the difficult global economic environment. In the face of slowing export growth, the current account deficit widened to above 10% of GDP, but inflation began to subside gradually.

Although the programme's macroeconomic scenario was revised downwards against the background of an uncertain international environment, its growth projections appear still optimistic, especially for 2012 when economic growth is projected to reach 1.5% before it accelerates quite markedly to 4% in 2014. The authorities have indicated upon submission of the programme that the on-going economic developments called for a further downgrading of the macroeconomic assumptions. A comprehensive revision is expected by mid-2012, after the 6 May general elections. The programme would have obviously benefited from presenting alternative growth scenarios, also to avoid that its macroeconomic framework becomes quickly outdated.

The fiscal responsibility legislation, adopted in 2010, compels the authorities to a gradual consolidation of public finances, in line with a set of numerical fiscal rules. Although the medium-term fiscal strategy presented in the programme follows the general guidelines, there are major risks to the realisation of the planned outcomes, not least due to the optimistic underlying macroeconomic scenario. According to the EFP, in 2011 the budget deficit reached 4.6% of GDP, which was higher than initially targeted, due to substantial revenue shortfalls amid slowing economic activity. Preliminary actual budgetary figures point to even higher deficit.

Over the medium term, a gradual deficit reduction to just below 3% of GDP by 2014 is projected. Compared to last years' programme, the pace of adjustment has been slowed down and is more back-loaded. The fiscal strategy foresees as of 2013 an expenditure-led fiscal adjustment through a reduction in the share of general government current expenditures as a percentage of GDP, resulting mainly from restraining pension outlays as well as public consumption, including the wage bill. However, the programme does not provide detailed information on the envisaged fiscal policy measures that will rein in current expenditure. The anticipated savings on current spending will be difficult to foster, as the social situation remains weak. From 2013, the general government revenue ratio is projected to fall despite the anticipated strengthening of private consumption and imports. A rigorous implementation of the fiscal responsibility provisions is key in fostering the country's long-term sustainability of public finance. However, the design and implementation of an appropriate set of policy measures to improve the composition and efficiency of general government expenditure, notably in the pension, healthcare and education systems as well as public administration will have to be urgently addressed.

The fiscal framework presented in the programme reflects the efforts made to provide more in-depth analysis, notably as regards public debt and the medium term debt

management strategy which is supported by a sensitivity analysis of alternative borrowing options. The programme also presents for the first time estimates of potential output growth and structural fiscal balances.

In 2011, a more subdued foreign demand weighed on the external position, which has been maintained in the aftermath of the 2009 crisis. In view of the slowdown ahead, the current account gap is expected to widen further, but should stay well below the pre-crisis levels as long as import growth lags export growth. Although the external imbalances have been significantly reduced since the 2009 crisis, dependence on external financing remains high. Foreign loans are likely to remain sizeable due to higher government borrowing abroad, but the sustained deleveraging by the private sector is poised to offset the negative impact on external indebtedness. In view of the ample foreign exchange reserves and gradually declining gross external debt relative to GDP coupled with a shift towards borrowing mostly long term, Serbia’s external sustainability appears relatively stable. However, it remains subject to a number of risk factors and uncertainties with respect to inter alia export capacity, FDI inflows, interest and exchange rate. Vigilance is required, as foreign financial resources could become scarce due to the sovereign debt problems and the on-going balance sheet repairs in the EU. The programme presents a comprehensive overview of past developments based on relevant indicators as regards the country's external sustainability but would benefit from a forward looking assessment including a discussion of the country's competitive position, as requested by the Commission.

Serbia has taken important steps towards transforming its economy, but a number of structural weaknesses persist and hamper the economic performance. Broad consensus has been reached on the need to shift to more balanced and sustainable growth, driven by exports and investment, which will bolster export expansion and create new jobs. So far, progress has been limited and further efforts will be necessary for restructuring the economy and improving the business environment, in particular by strengthening the rule of law and removing red tape, enhancing competition and the role of the private sector as well as tackling rigidities on the labour market. In line with the Commission's request, the programme would have benefited from a more thorough analysis of structural bottlenecks to growth and from the definition of a more elaborate strategy. To that end, the authorities will have to substantiate the reform agenda with the implementation roadmaps, timetables and budgetary impact assessments of the most important measures.

To sum up, the plausibility of the programme targets is constrained by an outdated macroeconomic scenario. The programme duly recognises that there are uncertainties stemming from both external and domestic environment, but the assessment of the potential impact is constrained by the absence of quantitative analysis of the various risk factors. Given the signals that the macroeconomic scenario presented in the programme has become unattainable, the credibility of the proposed fiscal plan has been undermined. This is further marred by the lack of details on the fiscal policy measures. It is also not clear from the programme which policies and measures would forge a structural shift to more sustainable growth based on exports and investment. It remains to be seen how this strategy would unfold, given the absence of binding plans for implementing structural reforms.

6.2 INTRODUCTION

Serbia's Economic and Fiscal Programme for the period 2012-2014 was submitted on 31 January 2012, following its adoption by government on 19 January. Contrary to past practice, this programme has not been endorsed by parliament as the country's strategic economic policy document setting out the medium-term macroeconomic and fiscal policy framework. According to the fiscal responsibility legislation, the parliament adopts annually a fiscal report covering the three-year budgetary cycle, but the authorities did not attempt to establish a link with the programme.

6.3 KEY POLICY CHALLENGES

In the medium term, Serbia's main challenge remains to establish a fully-fledged market economy, capable of coping with macroeconomic shocks and competitive pressures in the international environment. The programme recognises that further efforts are needed to that end.

The onus remains on a policy mix of monetary and fiscal measures. Among the economic policy guidelines defined in the programme for the period 2012-2014, sound public finances anchored by a set of specific numerical fiscal rules, defined in the revised Law on the budget system, have a predominant role. This revised fiscal framework, adopted in 2010, is an important step towards improving the sustainability of public finances. However, as the augmented growth-based rule for the fiscal deficit allows for deviation from target when GDP growth is below potential, the deficit remained relatively high in 2011 and is projected to decline only slightly in 2012, against the background of weak economic activity. A process of gradual and continued fiscal consolidation would require the design and implementation of specific cost saving measures with a view to reduce the relatively high ratio of current public spending. The programme acknowledges the need to address structural weaknesses and rigidities, which are significant obstacles to economic growth. In particular, an unfinished agenda of privatisation and incomplete enterprise restructuring as well as labour market weaknesses remain key challenges for policy makers.

6.4 ECONOMIC DEVELOPMENTS AND OUTLOOK

6.4.1 Recent macroeconomic developments

The programme presents a concise description of the state of the economy until the third quarter of 2011, using data available at the time of preparation of the programme.

Serbia's economy bounced back from the 2009 recession, with GDP up by 1% in 2010 and strengthening further by 1.6% in 2011. However, the export-driven recovery began to lose momentum in the second quarter of 2011 amid the looming downturn in Serbia's main trading partners. Private consumption remained constrained by eroded disposable incomes due to a jobless recovery and high inflation, but the stimulus from domestic demand strengthened owing to a pick-up in investment, mainly based on a revival of construction, the first time since 2009. Driven by imports of intermediate and capital goods in support of a rally in investment activity, import growth soared towards the end of the year. At the same time, export expansion withered with softening external demand despite the depreciation of the dinar later in the year, which led to a marked widening of

the current account deficit, to around 10.7% of GDP. Inflationary pressures, which had been building up from the middle of 2010 and peaked in April 2011 at close to 15%, subsided thanks to the fading base effect, easing of commodity and food prices and contained domestic pressures given the limited impact of hikes in administered prices and subdued private consumption. By the end of 2011, CPI inflation declined to 7% from 10.3% in 2010, but was still well above the upper boundary of the 3-6% target band for the end of the year set by the National Bank of Serbia (NBS). Despite an economic upturn in 2011, the situation on the labour market deteriorated further. The unemployment rate soared to 24.4%.19 Following a two-year nominal freeze, indexation of public sector salaries (and pensions) was re-introduced as of January 2011, and three adjustments were carried out during the year. Nevertheless, overall growth of net wages remained contained, up by 0.2% in real terms.

Box: Anchoring macroeconomic stability with economic programmes supported by IFIs

Serbia's macroeconomic stability has been broadly sustained owing to an economic recovery plan supported by the IMF under a 27-month Stand-By Arrangement (SBA) worth close to EUR 3 billion, out of which Serbia drew around EUR 1.5 billion. Following its expiry in mid-April 2011, a new precautionary SBA agreement was signed in September. Covering 18 months, effective as of September 29, the new deal was intended to commit the policy-makers to long-delayed structural reforms. However, the initial benchmarks mainly bound the authorities to the implementation of the new fiscal responsibility framework and further development of local financial markets to entrench macroeconomic stability against the backdrop of a deteriorating global environment. In the case of an economic slump, Serbia could resort to financial aid in the amount of EUR 1.1 billion. Following a review mission in November 2011 and a staff visit in early February 2012, the programme was put on hold due to the deviations in the 2012 budget bill from the underlying SBA agreement, in particular with regard to higher planned issuance of public debt (including government guarantees) and domestically-financed projects. Central to the agreement was the commitment by the authorities to make additional efforts in order to safeguard macroeconomic stability against the background of the global slowdown and the deepening sovereign debt crisis in the euro area.

In the context of the first IMF SBA, the EU committed its financial support to help the government address residual external and budgetary financing needs. In July 2011, the EU released upon a satisfactory fulfilment of condition requirements EUR 100 million, the first tranche of a macro-financial assistance loan facility (MFA). The provisional amount, granted at the end of 2009 in view of the adverse impact of the global crisis on the Serbian economy, was EUR 200 million, but the MFA funds were halved in the light of the lower foreign financing requirements and subsequently the need for emergency assistance by International Financial Institutions (IFIs).

6.4.2 Medium-term macroeconomic scenario

Compared to the previous years' submission, the macroeconomic scenario was revised downwards against the background of a worsening international environment, in line with the projections by external forecasting institutions available at the time of preparing the programme. Upon the submission, the authorities have agreed that the deterioration in the economic climate called for a further downgrading of the macroeconomic assumptions. The GDP growth projection for 2012 is likely to be significantly reduced and its fiscal consequences addressed. However, a comprehensive revision is unlikely to be forthcoming due to imminent elections on 6 May.

[19] This rate refers to the age group 15-64, in line with the international methodology. According to the Labour Force Survey (LFS); the unemployment rate for people aged 15 and above stood at 23.7% at end-November 2011.

The programme's macroeconomic outlook projects real GDP growth to reach 1.5% in 2012 and to accelerate to 3% in 2013 and 4% in 2014 which is optimistic, especially for 2012. Exports and investment would be the key drivers of growth as the programme continues to anticipate a shift to a more sustainable growth pattern. Employment growth is projected to turn positive in 2012 and pick up over the period 2013-2014 while average annual inflation is set to decelerate to 4.1% in 2012 and stabilise thereafter.

How this strategy would unfold remains unclear. The programme does not identify the policies and measures that would underpin the envisaged scenario, notably as regards productivity and employment growth. In the light of the elevated global uncertainties, the new election cycle, with a general vote in the spring and presidential elections in the autumn, and also given the absence of binding plans for structural reforms the medium-term macroeconomic outlook is exposed to substantial risks. The programme would have benefited from presenting an alternative low growth scenario.

Macroeconomic developments

	2010	2011	2012	2013	2014
Real GDP (% change)	1.0	1.6	1.5	3.0	4.0
Contributions:					
- Final domestic demand	-2.7	1.2	0.2	1.6	2.3
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	3.7	0.4	1.3	1.4	1.6
Employment (% change)	-8.4	-6.6	0.5	1.0	1.5
Unemployment rate (%)	19.2	23.2	22.9	22.0	20.8
GDP deflator (% change)	3.3	7.9	4.2	3.7	4.0
CPI inflation, annual average (%)	6.1	11.2	4.1	3.7	4.0
Current account balance (% of GDP)	-7.9	-10.7	-8.4	-7.7	-7.4

Sources: Economic and Fiscal Programme (EFP) 2012, for 2010 and 2011 the latest official national statistics where possible.

Real sector

Compared to the previous programme, the growth trajectory has flattened as a result of the anticipated temporary slowdown in 2012. The programme projects real growth to moderate to 1.5% in 2012, down from an estimated 2% in 2011, and to accelerate to 3% in 2013 and 4% in 2014. The stimulus to growth is expected to be initially driven by investments and exports in 2012 while becoming more broad-based over 2013-2014, with positive contributions from both external and domestic demand, assuming that exports remain robust despite more subdued foreign demand, and are further strengthened by sustained investment in the export-oriented sectors. As the improving economic performance gradually translates into new jobs and higher wages, the economy's output is seen to be supported by private consumption growth that would turn positive (1.1%) in 2013 while government spending is projected to remain entrenched over the medium term. The macroeconomic scenario is overly optimistic, as the key

drivers of growth – export expansion and investment activity, increasing at an average of 10.9% and 4.5% respectively over the programme's period, are exposed to significant risks. On the production side, the new growth paradigm implies that economic activity would be increasingly driven by export-oriented industrial sectors. Yet, the contribution of agriculture to GDP growth is projected to remain high, at 0.4 percentage points per year.

The programme presents for the first time the official calculations of cyclical conditions (as measured by the difference between the potential and actual growth rates – the output gap) in the period 2002-2014, based on a Cobb-Douglas production function. In step with the installation of new production facilities, particularly in the tradable goods sectors including the agricultural sector, the potential output of Serbia's economy is set to increase to around 3% in 2014, the level reached before the 2009 recession. The risk of overheating is identified towards the end of the programme period as the output gap turns positive, which could lead to inflationary pressures.

Inflation

According to the programme, inflationary expectations will stay broadly anchored throughout the medium term within the existing inflation targeting policy.20 The National Bank of Serbia (NBS) maintains a target band for the end-year CPI inflation rate at 4.5±1.5% in 2012 and 2013. Inflation fell below the upper limit of the range in the first quarter of 2012 thanks to the fading base effects of earlier commodity price shocks and weak consumer spending, and is expected to stabilise around 4% over the programme period.

The projection of a stable inflation assumes a conservative monetary policy and restrictive fiscal stance, exercising restraint in hikes of public sector wages and pensions as well as of administered prices and excise duties.21 However, achieving price stability will be challenging in the face of volatile global commodity prices and structural shortcomings,22 in particular the substantial state control over prices23 and the knock-on effect of the exchange rate fluctuations. The programme acknowledges the risks to the inflationary path, but does not define risk mitigation measures.

Monetary and exchange rate policy

The presentation of monetary policies in the programme is very brief and does not comply with the outline. The NBS remains committed to price stability as its main objective. It has been gearing its monetary course through regular adjustments of the

[20] While the NBS has been pursuing inflation targeting since 2006, the current framework was put in place on 1 January 2009, when the NBS began setting a broad band around the targeted consumer price index (CPI) inflation instead of core inflation, as previously.

[21] To keep price growth under control, the government adopted a decree, effective until June 2012, by which it put an administrative cap on trade margins.

[22] Inflation in Serbia remains much higher than in countries with comparable income levels. The inflation pattern points to relatively high sensitivity of prices to common external shocks as well as failures in the market formation of prices, which prompted occasional state interventions, e.g. as in 2010, following the shortage of food items.

[23] Administered prices account for more than 20% of the CPI inflation basket, with regulated energy prices accounting for around half of this share.

two-week repo interest rate in line with price developments. From mid-2011, the stance has been relaxed, as the NBS abandoned tightening of monetary conditions in the face of signs that inflation is slowing and the dinar is strengthening. The reference interest rate, which had been hiked to 12.5% in April 2011, was slashed to 9.5% by the end of February 2012.

The NBS takes into consideration exchange rate stability in pursuing its policy objectives. Within the existing monetary setting, foreign exchange operations on the interbank market are undertaken to prevent excessive exchange rate volatility, with the view of limiting pass-through effects to inflation and safeguarding financial stability given the high degree of euroisation of the economy. In 2010, the three-month swaps of foreign currencies were introduced as a regular monetary instrument to facilitate transactions between the NBS and commercial banks. However, the NBS continued to resort to extensive selling of currency reserves on the foreign exchange market, which is largely motivated to buffer depreciation pressures on the dinar. In 2011, the NBS's interventions on the interbank market were less frequent as the exchange rate stayed relatively stable.24 They were stepped up in early 2012 to avert the major slide of the dinar's value in the face of a looming standstill in economic activity and the spike in risk premia throughout the region.25

In the medium term, the effectiveness of monetary policy will be tested against the effective pursuit of dual objectives by the NBS, namely preserving financial stability while being committed to inflation targeting. Limiting dinar volatility, amid the mounting economic and fiscal pressures, with monetary easing underway, will be a particular challenge.

External sector

In response to the Commission's request to substantiate the analysis of the country's external sustainability, the programme presents a more comprehensive overview of the past developments based on sustainability indicators, but it falls short in providing a forward looking assessment, including a discussion of the country's competitiveness position. External imbalances have been significantly reduced since the 2009 crisis. The current account deficit narrowed to around 7% of GDP in 2010, down from over 20% before the crisis, and the merchandise trade deficit fell to around 18% of GDP, down from 26%. The current account gap is expected to temporarily widen in 2012 before declining in the outer years, staying well below the pre-crisis levels over the programme's period. The underlying improvement in the trade balance (goods and services) to a deficit of 12.6% in 2014 assumes that export growth will significantly outpace that of imports, although the latter are expected to accelerate in line with increased investment and the recovery of private consumption. If the underlying assumptions fail to materialise, either due to a suppressed export activity or a rally of imports as a result of a strong domestic demand and/or a global commodity price shock, the balance of payments projections could be significantly undermined.

[24] Although the dinar was on a depreciating trend in the second half of 2011, over the year the RSD/EUR exchange rate strengthened by about 1.5%, also as result of higher capital inflows.

[25] In March, the RSD/EUR exchange rate hit the historic low, trading at over RSD111 per EUR 1.

The dependence on external financing has remained high. The programme assumes that over the next three years around 40% of the trade deficit will be covered by a surplus on the current transfers account, while the rising interest payments would incur deficits on the current incomes account. The current account deficit is expected to be financed through inflows of both FDI and portfolio investment, estimated to average around EUR 2 billion per year. Foreign loans are likely to remain sizeable due to higher government borrowing abroad, but the sustained deleveraging by the private sector is poised to offset the negative impact on external indebtedness. Against the background of the expected foreign currency inflows, official foreign exchange reserves are expected to remain largely stable and sufficient to cover more than eight months of imports of goods and services throughout the programme period.

In view of the ample foreign exchange reserves and gradually declining gross external debt relative to GDP (forecast to drop to around 70% of GDP in 2014) coupled with a shift towards borrowing mostly long term, Serbia's external sustainability does not cause immediate concerns. However, it remains subject to a number of risk factors and uncertainties with respect to export capacity, FDI inflows, and interest rates. A substantial private savings-investment gap remains to be closely monitored. The exchange rate volatility is also a point to watch, especially in the face of the recent depreciation pressures. Given the high level of 'euroisation' of the Serbian economy, the negative impact of dinar depreciation on debt could be considerable, notwithstanding the assumed beneficial effects to Serbia's export competitiveness. In order to avoid the risk of the appreciation of the real effective exchange rate, it will be crucial to keep inflationary pressures contained.

Financial sector

The programme does not elaborate on the medium-term prospects regarding the financial intermediation role of the sector. In the light of the substantial increase in NPLs and subdued credit growth, a more in-depth discussion of the financing of the real economy would have been welcomed.

Main risks to the macroeconomic scenario

The Serbian economy has a potential to strengthen in the medium term. However, the anticipated pace of the recovery is overly optimistic against the background of the fragile international environment and the delays in economic restructuring. The programme duly recognises that there are uncertainties stemming from both external and domestic environment, but the assessment of the potential impact is constrained by the absence of quantitative analysis of the various risk factors on the main macroeconomic aggregates. In that sense, the programme would have benefited from presenting alternative growth and risk scenarios.

There are significant risks related to the developments in the external environment. The envisaged economic upturn is based on a sustained export expansion and investment spending which will depend on the recovery of foreign demand. The availability of capital on the external markets at reasonable conditions will be crucial for the financing of investment in production facilities and infrastructure projects given the limited domestic resources and relatively high interest rates. Exchange rate fluctuations and commodity price shocks represent a further threat to the development of the export-oriented sector and through an adverse wealth effect. In particular, oil price hikes could

spur inflationary pressures, exposing the anticipated path of a gradual economic recovery and decelerating inflation to a significant risk.

In the domestic environment, risks remain predominantly on the downside. The implementation of structural adjustments, which are necessary for a shift of the economy towards a more balanced, resilient and sustainable growth, has been faltering. If, on the other hand, political will for reforms is mustered after the elections and also with a view to advancing to a further stage in the EU accession process, the medium-term outlook may well improve.

6.5 PUBLIC FINANCE

The key objective of fiscal policy is to enhance the long-term sustainability of Serbia's public finances. The fiscal responsibility legislation, adopted in 2010, compelled the authorities to a gradual consolidation of public finances, based on a multi-annual budgetary process and on a set of binding numerical fiscal rules with a strong cyclical component, formalised in the revised Law on the budget system. It commits the policy makers to a medium-term deficit target of 1% of GDP and to keep public debt (without restitution costs) below 45% of GDP. Moreover, the framework foresees to cap over the medium-term the outlays for public sector wages and for pensions, respectively, to 8 and 10% of GDP. The law also defined a new indexation formula for public sector wages and pensions, with three adjustments in 2011 and bi-annual indexation thereafter that would be modified, should the indexation mechanism threaten the achievement of the planned deficit.

In this context, the medium-term fiscal strategy projects a gradual reduction of the general government deficit from 4.3% of GDP in 2012 to 2.9% in 2014, based on an expenditure-led adjustment.

However, in view of the optimistic macroeconomic scenario presented in the programme, the proposed fiscal plan may turn out to be unrealistic. Moreover, the credibility of the fiscal strategy is further undermined by the lack of information regarding the specific measures to bring down the spending ratio. In addition, the downward revision of the 2011 GDP recently published by the statistical office of Serbia changes ratios to GDP, notably increasing deficit and debt, and impacts on the overall medium-term fiscal strategy. Revisions of the 2012 budget and of the medium-term fiscal strategy are expected by mid-2012, after the general elections of 6 May. As public debt will have exceeded the 45% debt/GDP ceiling in 2011, the Budget System Law mandates that the government submit a plan for reduction of the debt ratio to the National Assembly together with the budget for the following year.

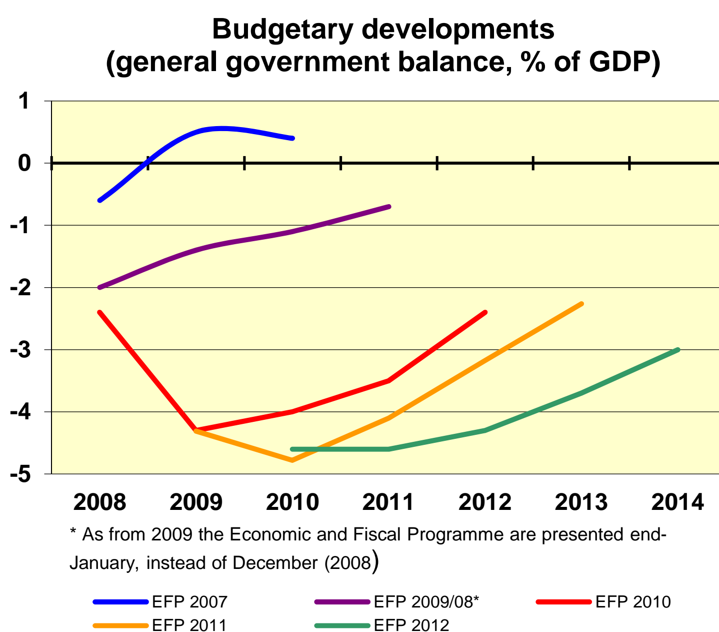
6.5.1 Budget implementation in 2011

According to the EFP, in 2011, the general government deficit was kept almost unchanged at 4.6% of GDP (preliminary figures, based on the latest GDP data, show a deficit of around 5.1% of GDP) from the year before, falling short of the planned adjustment to 4.1% of GDP in the previous submission. In October 2011, a supplementary budget was passed by parliament, in line with the revised budgetary plans in the framework of the new precautionary agreement with the IMF. A higher deficit (4.6% of GDP) was justified by a downward revision of growth and in line with the fiscal

rules in place, where the underlying formula set the necessary adjustment in relation to slower-than-expected GDP growth. Revisions of the budget were also prompted by the adoption of the bill on the financing of local governments, which inter alia increased the share of personal income tax that municipalities retain from 40% to 80%.

In 2011, public finances were challenged by a considerable revenue shortfall. In the first half of the year, revenue performance was solid notwithstanding the scraping of a temporary 10% tax on mobile services26 and the on-going lowering of customs tariffs in line with the trade agreement under the Stability and Association Agreement. Pressures on the budget mounted since the summer in the face of the dwindling inflows of VAT revenue as the gradual economic upturn was losing momentum. Personal income tax revenue as well as social contributions have been boosted by the unfreezing of wages in the public sector, but still remained subdued given the weak labour market. Against this background, the share of revenues as a percentage of GDP is estimated in the programme to have fallen by more than 2 percentage points compared to 2010.

The situation remained tense also on the expenditure side, as a two-year temporary nominal freeze of public administration salaries and pensions came to an end.27 Additional social assistance spending and subsidies were provided in response to the weak labour market performance and poor living conditions, yet were contained relative to GDP. Against this background, current expenditure stayed entrenched at more than 90% of total expenditures. Nevertheless, the authorities were able to further a spending cut of RSD 15-20 billion in line with the revised budget with some additional savings and the expenditure restraint was successfully enforced. Overall, the expenditure ratio is estimated in the programme to have decreased by 2 percentage points.



[26] The tax was introduced in the framework of the 2009-2011 SBA programme as an ad hoc corrective measure in order to compensate for the sizeable revenue shortfall in the face of a sharp economic downturn.

[27] Nominal public sector wages and pensions were frozen in 2009, as a part of the emergency measures agreed with the IMF to limit the fiscal slippage in the aftermath of the crisis.

6.5.2 Medium-term budgetary strategy

The medium-term fiscal strategy presented in the programme projects a gradual reduction of the fiscal deficit, by 1.7 percentage points of GDP from 4.6% of GDP in 2011 to 2.9% in 2014. Compared to previous years' programme, the pace of adjustment has been slowed down, in line with the flexibility enshrined in the fiscal rule with respect to the cyclical position of the economy. The programme envisages an equivalent reduction in general government expenditure, as a percentage of GDP, resulting mainly from restraining current expenditure, in particular pension outlays, public sector payroll, public consumption and spending on subsidies so as to maintain public investment at an average level of 3.8% of GDP. The general government revenue ratio is projected to increase in 2012, but to fall again to the 2011 level by 2014 despite the anticipated strengthening of private consumption and imports.

The adjustment profile of the fiscal strategy is essentially back-loaded, as the spending ratio is programmed to increase in 2012 (by half a percentage point), before it is set to decline by around one percentage point per year in 2013 and 2014. Total revenues in 2012 are envisaged to increase by an even larger extent (by 0.8 percentage points), resulting in a slight improvement of the fiscal balance compared to 2011.

In the context of the new precautionary SBA, the authorities had pledged to reduce the fiscal deficit in 2012. Due to lower than earlier projected real GDP growth, the initial deficit target was raised by 0.3 percentage point, to 4.25% of GDP. This increase was smaller than allowed for by the numerical rule and agreed for the sake of safeguarding the debt ceiling. The authorities envisaged enhanced revenue mobilisation through better tax compliance and, in addition, pledged to ensure expenditure cuts, amounting to 0.75% of GDP. However, the budget bill, which was adopted by the parliament in December 2011, deviates from the initial agreement with the IMF. Higher outlays for investment, interest payment as well as subsidies were not compensated for by savings in consumption and transfers, leading to an increase in total expenditure by 0.5 percentage points of GDP, as shown by aggregate data in the EFP. The first review under the SBA has been delayed and putting public finances back on track will need to be a priority of the administration after the elections. The programme provides hardly any information about the 2012 budget and its underlying policies. Thus, it is difficult to assess the precise factors for the planned increase in the spending ratio, in particular with respect to public investment and interest costs. Likewise, the strong increase in the revenue seems somewhat surprising in view of cyclical developments, and may be based on an overestimation of the short-term effects of better tax compliance. Overall, the EFP itself does not allow to obtain a clear view about the plausibility of the 2012 budget.

With respect to the outer years of the programme, the strategy assumes little change in the structure of general government revenue, while the revenue ratio is expected to decline in 2013 and 2014. No tax rate hikes other than in excises as a part of further harmonisation with the EU law have been envisaged. The authorities consider that putting a firm grip on tax discipline will buoy revenue collection, but do not provide further details on the envisaged measures.

With respect to the spending side, although the provisions require the fiscal strategy to be accompanied by a medium-term expenditure plan, the programme remains silent on the details of the fiscal policy measures to be taken to rein in public expenditure. In particular, as the social situation remains weak, the anticipated savings on current

spending will be difficult to foster, especially as regards the rationalisation of the public administration employment.

The fiscal rules have been designed to ensure that the fiscal adjustment is achieved mainly through a reduction as well as rebalancing of general government expenditure towards growth-enhancing capital spending. However, it will be difficult to curb substantially the share of outlays for the public sector salaries and pensions by 2015 given the projected growth path and the regular indexation.28 In view of the high share of mandatory expenditure, room for increasing capital expenditure is likely to remain limited. The available funds are earmarked for priority infrastructure projects, such as the Corridor 10 roads and railways. A detailed public investment plan, albeit a vital part to a new medium-term expenditure framework, has not yet been divulged.

Composition of the budgetary adjustment (% of GDP)

	2010	2011	2012	2013	2014	Change: 2011-14
Revenues	41.0	39.1	39.9	39.4	39.1	0.0
- Taxes and social security contributions	36.1	33.8	34.1	34.1	34.0	0.2
- Other (residual)	5.8	5.3	5.8	5.3	5.1	-0.2
Expenditure	45.6	43.7	44.2	43.1	42.1	-1.6
- Primary expenditure	44.5	42.3	42.4	41.2	40.1	-2.2
of which:						
Gross fixed capital formation	3.5	3.5	4.0	3.8	3.8	0.3
Consumption	19.0	18.1	17.7	16.9	16.3	-1.8
Transfers & subsidies	21.9	20.8	20.7	20.5	20.0	-0.8
Other (residual)	0.1	-0.1	0.0	0.0	0.0	0.1
- Interest payments	1.1	1.4	1.8	1.9	2.0	0.6
Budget balance	-4.6	-4.6	-4.3	-3.7	-3.0	1.6
- Cyclically adjusted	-4.1	-4.2	-3.9	-3.6	-3.1	1.1
Primary balance	-3.5	-3.2	-2.5	-1.6	-1.0	2.2
Gross debt level	42.7	42.4	44.0	44.9	44.4	2.0

Economic and Fiscal Programme (EFP) 2012, ECFIN calculations

Overall, notwithstanding the fiscal framework based on formulae-based rules, the medium-term fiscal consolidation strategy is exposed to major implementation risks. Some of these risks are duly acknowledged and their impact on the 2012 deficit quantified in the programme (e.g. reduction in the collection of social insurance contributions). Thus, a 1% lower collection of social contributions would increase the deficit by 0.1 percentage point. The programme, however, tends to underscore the fragile political, macroeconomic and social conditions, which may undermine the planned fiscal course.

Pursuing expenditure-based consolidation amid uncertain economic environment will be challenging. Freeing fiscal space to make way for higher public investment hinges on the

[28] In addition to price developments, the indexation formula also takes into account growth performance: the April adjustments in 2012 and 2013 will be topped by half of the GDP growth.

authorities' willingness and ability to restrain current expenditure, when the employment prospects are not so strong and the social situation is tensed. In particular, the risk of a budgetary slippage increased substantially with the recent nationalisation of the country's biggest steel mill.29 The full effects of the fiscal decentralisation remain largely unclear, as the new law has only been in force since October 2011. There are also uncertainties related to the budgetary impact of the recent laws on restitution/denationalization and public property. Furthermore, the prospects with regard to budgetary financing might falter, as the arrangements with International Financial Institutions have been shelved due to the political standstill in the run up to general elections. The lack of firm commitments as regards structural reforms, which aim at enhancing cost-effectiveness of the public sector as well as improving the overall business climate, raises additional concerns about the plausibility of the fiscal targets.

On a more technical note, the authorities have made remarkable efforts to estimate budgetary balances in cyclically-adjusted terms, and thereof assess fiscal policy in terms of its stance and impulse. The authorities may consider it equally useful to make fully-fledged alternative scenarios based on a sensitivity analysis of the fiscal aggregates to the main macroeconomic variables an integral part of their medium-term budgetary planning.

Budgetary implications of "major structural reforms"

The programme announces structural adjustments in health care, education and social welfare, which are expected to curb public spending. In cumulative terms, the planned reforms are estimated to foster savings of around 1% of GDP over the next three years. In absence of a detailed implementation timetable, the net fiscal effects of measures remain to be specified, however.

6.5.3 General government debt

Fiscal sustainability has become a major issue of concern, as public debt30 soared and by end-2011 exceeded the ceiling of 45% of GDP. The government stepped up the issuance of debt securities in the face of the widening budgetary gap. Treasury-bill auctions met ample demand, as domestic banks favoured investment in short-term government securities owing to higher yield, especially amid the appreciation of the dinar. This paved the way to a successful bid for USD 1 billion on the international market; in September 2011, the first 10-year eurobond was issued, with an annual coupon rate of 7.25%.

In the programme, the authorities pledge to abide by the fiscal rule and keep public debt, excluding restitution cost, below the legal limit throughout the medium term. However, it remains to be seen how this can be achieved, as the projected reduction of primary balance is challenged by the uncertainties in the macroeconomic outlook. Moreover, the planned large-scale infrastructure projects, which are to be partly financed by public

[29] The government took over the steel mill with some 5,500 workers in order to mitigate the social impact, following the decision by US Steel to close its Serbian subsidiary.

[30] The national definition of public debt deviates from ESA-95 methodology, as it includes all general government guarantees, irrespective of whether their actual activation. Contingent liabilities account for some 15% of total public debt, of which three quarters represent guarantees to the state road and railway companies.

means, may prompt additional government borrowing and led to a further increase in public debt. There is also a risk that indebtedness surges as a result of a continued depreciation of the dinar.

The programme provides a very sound and comprehensive discussion of the country's debt management strategy. The authorities justify the adopted strategy based on the World Bank model, by analysing the cost and risks of four borrowing alternatives against a set of macroeconomic shocks. Amongst the options, which blend to varying degrees borrowing in domestic and foreign currency, the preferred strategy "S4" aims at issuing debt securities with long-end maturities, denominated in dinars. The choice between the alternative strategies has been motivated by testing the sensitivity of public debt to a dinar depreciation, an interest hike and a simultaneous shock of the two. The sensitivity analysis reveals that the impact of the interest rate hike is limited (for the chosen strategy, an increase in the domestic interest rate of 5% would lead to an increase in public debt of 0.5%, to 43% of GDP). The adverse effect is more substantial in the case of a broad-based depreciation of the dinar (for the chosen strategy, a 15% depreciation of the dinar against all currencies results in 5 percentage points higher public debt, to 47.4% of GDP). In view of the recent significant depreciation pressures, the debt management strategy faces significant implementation risks.

The plan of the authorities to further extend maturity on domestic treasury bills and bonds during the programme period is welcome but could prove difficult, especially given the recent lack of investor's interest. Going forward, sluggish economic activity, shallow domestic capital markets and exchange rate volatility could discourage investors' interest in treasury bills with long-end maturities. Access to financial resources may become more constrained and costly, but the financing of the fiscal gap should not come under threat, provided that macroeconomic stability is preserved.31 The programme remains silent on the plans to raise privatisation proceeds, given that the recent attempts to sell the majority stakes in the remaining state owned companies (telecoms incumbent, national air carrier, a pharmaceutical firm) were unsuccessful.

The programme also advocates the development of municipal bond markets. While the objective – to raise resources for financing local government investment needs – is generally sound, the implementation needs to be tested against threats to overall public debt sustainability.

The issuance of dinar-denominated treasury bills since 2009 has resulted in a steady increase in the share of dinar-denominated debt, but foreign debt still accounts for more than half of the currency portfolio and is predominantly euro-denominated.32 The repayment profile of the total public debt remains largely long-term and evenly distributed over time, despite the sustained short-term borrowing through treasury-bills. The share of debt with a fixed interest rate has been stabilised at around 70% of the debt portfolio. According to the programme, the debt portfolio appears relatively resilient to

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[31] In 2011, the prospects for budgetary financing became more upbeat after Serbia's sovereign credit ratings improved thanks to the efforts to strengthen the macro-fiscal policy framework. In early 2012, Serbia keeps a stable outlook on BB by S&P and BB- by Fitch.

[32] At end-December 2011, around 55% of Serbian public debt is denominated in euro, 18% in Serbian dinar, 17% in US dollar, 7% in special drawing rights (SDR) and 3% in other currencies (source: Bulletin of Public Finance, March 2012).

limited exchange rate fluctuations and interest rate hikes. However, the impact could be more substantial in case of larger and simultaneous shocks.

6.5.4 Quality of public finances and institutional features

Contrary to previous programmes, no information on the institutional features of public finances was included. An update of the recent actions would be welcome, given that the medium-term fiscal strategy is predicated on improved quality of public finances through an on-going strengthening of the legal framework. Against the background of a significant fiscal deterioration in the aftermath of the 2009 crisis, the authorities launched an overhaul of the budget system in 2010. Putting in place multi-annual budgetary programming33 together with binding fiscal rules and procedures, including the setting-up of a fiscal council, was an important step towards instilling fiscal discipline. A consistent implementation of the legislation will be crucial in order to achieve the planned fiscal adjustments and thereby help lift the growth potential of Serbia's economy.

A forward-looking budgetary process, the fiscal responsibility provisions and sustained progress in furthering fiscal accountability34 constitute a comprehensive framework for sound public finance management. Yet, its effectiveness is being tested against the unfavourable economic conditions, which hinder the achievement of the fiscal objectives. Capital expenditure is strained by revenue shortfalls and rising debt-servicing payments and it is likely to stay squeezed, given that the cost of population ageing is estimated to be significant, despite the 2010 pension reform. The new law, which will be phased in gradually over the period 2011-2022, extends the working period and age for assuming pension rights, tightens up the rules on early retirement and adjusts the indexation mechanism to be based partly on inflation and partly on growth performance.

Going forward, further reforms will be necessary in order to enhance the long-term sustainability of public finances. The new government will need to make additional adjustments in the pension and healthcare systems, as well in public administration in such a way to yield savings as well as to improve efficiency. The key challenge remains to restructure general government expenditure in a more flexible way. In the current circumstances, it will be essential to strike a right balance between trimming current spending to make room for growth-enhancing investment and keeping the appropriate social safety nets. To allow additional resources to be channelled towards more productive public spending, the authorities will also have to speed up revenue mobilisation, including by strengthening administration capacity in tax collection. Further Public Finance Management (PFM) reforms and, in particular, implementation of some elements of the existing legislation will be necessary to strengthen transparency, reliability and efficiency of public finances.

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[33] According to the revised law, the three-year budgetary planning must be accompanied by a medium-term expenditure framework, a public investment plan and a risk assessment.

[34] The State Audit Institution, an independent external audit body, audited the 2010 State Budget and extended the audits of the financial statements of public enterprises. Progress has been seen in the field of public internal financial control (PIFC),

6.6 STRUCTURAL REFORMS

6.6.1 Obstacles to growth and the structural reform agenda

Serbia has taken important steps towards transforming its economy, but a number of structural weaknesses persist and hamper the economic performance. Although these weaknesses are acknowledged, the programme would have benefited from a more thorough analysis of structural bottlenecks to growth and from the formulation of a more explicit strategy to address them, as requested by the Commission. The authorities acknowledge that they will need to step up structural reforms. In particular, they stress the importance of further strengthening the rule of law and removing red tape, completing privatisation and enhancing the business environment, competition and the role of the private sector. However, while the EFP mentions structural weaknesses in the functioning of the labour market, it does not present any analysis or plan for structural reforms in this area.

6.6.2 Key areas of structural reform

The country's 2010 development strategy for the period 2010-2020 outlines the objectives of the new growth paradigm – to upgrade the productive capacity of the economy and create a climate conducive to increased foreign investment – but yet remains to be backed by a concrete action plan. Measures and their sequencing still need to be clearly defined and their fiscal impact estimated. The programme provides some information on past reforms but tends to only outline main objectives over the medium-term.

Product and capital markets

The state influence in the economy remains high, with the private sector currently accounting for around 60% of GDP and total employment. It is largely a consequence of the unfinished privatisation and/or liquidation of socially and state owned enterprises and local utilities, which has been on-going since 2001. While the completion of the privatisation process is considered as one of the key priorities, the programme is not fully explicit on future steps and focuses on the description of the situation up to September 2011. Following the repeal of about 600 sale contracts signed between 2002-2009 due non-compliance with some or all of the five standard contract obligations, there are still 500 socially owned firms to be sold through auction/tender procedures or filed for bankruptcy.35 Privatisation of the state owned companies is largely incomplete, since the tenders for sale did not attract the expected demand. The state retains the majority shareholding in the large network industries, such as the national electric power company, the telecoms incumbent operator, the capital's airport, and the air carrier. More recently, furthermore, a wave of re-nationalisations has been underway. In January 2012, the state repurchased the country's biggest steel mill from US Steel for a symbolic price

[35] The bankruptcy law, which entered into force in 2010, has improved market exit procedures, including by establishing automatic bankruptcy in cases where the firm's accounts had been blocked for more than 3 years. However, the efficiency of the courts is constrained in view of the considerable backlog of bankruptcy cases. The authorities have instituted out-of-court settlements, in order to speed up the privatisation process.

of USD 1 and also brought back Telekom into full state ownership after buying out the 20% stake, held by the Greek telecom operator OTE since 1997. According to the programme, the objective remains to find strategic investors, but the policy efforts over the medium term shall focus – where appropriate – on the reorganisation of the companies, including financial consolidation, restructuring and improvement of management practices, as well as their corporatisation into closed joint stock companies. To facilitate the privatisation of those enterprises in which the state retains a stake, the government already decided to distribute free shares worth 15% of the company's equity to those citizens who have not benefited from any free share distribution in the past.36 Privatisation of the companies in the infrastructure sectors and public utilities, of which 500 are operated by the local communities, are to remain an outstanding issue, as the strategies towards their liberalisation have still to be defined.37 However, the programme rules out the possibility that natural monopolies on local level will not be privatised.

Apart from the heavy state involvement, market mechanisms remain hampered by legal uncertainty, red tape, insufficient competition, sectoral distortions and infrastructure bottlenecks. While important steps were taken towards establishing legal predictability, including by the recent adoption of a law on restitution, the business environment continues to be constrained by weak enforcement of the rule of law. A number of barriers to doing business persist, due to the delays or flaws in the implementation of a comprehensive regulatory reform, dubbed the regulatory guillotine.38 The programme recognises that further effort is needed to improve the business environment, but falls short of proposing a concrete implementation plan. Likewise, no details are available as regards the pledge for an overhaul of the system of fiscal incentives, which aim at supporting businesses in upgrading the productive capacity of the economy.

The programme's main goals in the financial sector are to preserve stability, reduce costs of banking intermediation and expand the range of financial sources also with a view to contribute to the financing of investment. In the banking sector, foreign banks account for around 70% of the total assets and the subsidiaries of Austrian, Greek and Italian banks are in the top five banks. Against potential risks stemming from deleveraging pressures in the parent banks, the Serbian banking sector continues to be adequately capitalised and liquid, thanks to a prudent monetary policy. However, the banks are exposed to credit risk, in the light of the substantial exchange rate risk related to the high degree of 'euroisation' as well as the impaired banks' balance sheets.39 The monetary authorities have taken steps, including a 'dinarisation' strategy, with the aim of diversifying financial instruments and improving investors' protection. Further

[36] The distribution of the remaining state shares was carried out in the oil company NIS in 2010 and in the airport operator Nikola Tesla in 2011. The government announced that a 21.5% stake of Telekom would be given away in the first quarter of 2012, but did not disclose any plans regarding the national electric power company EPS.

[37] By 2012, oil derivatives imports and fixed telephony have been fully liberalised, while the process is still on-going in the electricity sector.

[38] Since its launch in 2009, around two thirds out of 304 recommendations have been adopted and around 36 recommendations are still the subject of parliamentary procedure, while 73 recommendations have not yet been implemented. According to the programme, estimated savings have reached EUR 121 million out of EUR 183 million planned.

[39] At end-2011, gross non-performing loans (NPL) as a percentage of total loans exceeded 19%, largely due to an increase in the corporate NPL ratio.

adjustments in the legislative and regulatory framework of the financial system are envisaged to forge financial stability as well as to support the deepening of Serbia's capital market. The programme announces the finalisation of the privatisation process in the banking sector,40 the development of investment and pension funds and public-private partnerships as well as the establishment of a national development bank, with the aim of mobilising resources to boost investment.

Labour market

While poor labour market performance is one of the main concerns, the programme does not elaborate on the planned policy actions over the medium term. Despite a rebound in economic activity since the 2009 crisis, the situation continued to deteriorate in 2011, with the unemployment rate soaring from 14% to above 24%, the employment rate barely reaching 50% and the activity rate at just under 60%. Structural unemployment, in particular among educated young people, and widespread informal employment are exacerbated by persistent systemic rigidities. Changes in the institutional arrangements, including of wage bargaining, as well as adjustments of the pension and tax/benefit systems will need to be addressed.

In the face of modest and jobless growth, the biggest challenge in the medium term is however to improve substantially employment opportunities. The large share of unfilled job vacancies, despite high unemployment, points to a shortage of skilled labour and a major mismatch of qualifications. Further reforms of the education and vocational training systems, along with lifelong learning, would help to respond better to labour market needs.

Other reform areas

The programme underscores as priority those actions which will lead to a rationalisation of public spending over the medium term, either through parametric adjustments or by way of strengthening discipline and control. Reforms of the pension, health care, education, social welfare and state aid systems are announced. The authorities have already initiated an overhaul of the social welfare system due to a precarious social situation, with a significant rise in both absolute and relative poverty rates since 2009. The reform aims at targeting better social transfers and improving protection for the most vulnerable groups, but concrete measures are not elaborated in the programme. Decentralisation of provision of social welfare services and capacity building are deemed to further strengthen social inclusion. The revisions in the pension, healthcare and education sectors, which have been identified with the help of the World Bank, are mentioned as reform priorities, but the presentation lacks detail about planned policy measures, timeline for implementation and fiscal impact. There are some indications of savings from the rationalisation of schools and improvement of the collection of health contributions. The same holds true for the announced reduction of subsidies to firms. It appears that a defined strategy for implementation of key policies remains outstanding; a challenge that will need to be tackled without delay.

[40] However, the state has assumed majority ownership over local lender Privredna Banka, raising the stake to almost 65% following a capital injection in March 2012.

6.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Having regard to the EU standards for presenting a medium-term economic policy plan, Serbia's programme is a largely suitable document. Effort was made in responding to the calls for further improvement, in particular as regards substantiating the fiscal policy strategy with a more in-depth analysis. More information was provided also as regards the sustainability of the external position. The authorities are encouraged to further streamline the document, by enhancing partnership and co-ordination between all relevant stakeholders in the area of economic policies, with a view of ensuring consistency in the implementation of fiscal, monetary and structural strategies.

As regards the macroeconomic framework, the programme gives a clear and concise overview of past economic developments, based on the relevant data available at the time of submission. In the light of the current unstable environment, the authorities may consider it useful to further complement the macroeconomic projections with alternative scenarios, as this will highlight the impact of potential shocks/risks through the entire spectre of macroeconomic aggregates.

As regards the fiscal framework, the programme largely adheres to the requirements specified in the programme guidelines. Fiscal data are presented according to the IMF General Financial Statistics (GFS) methodology. In response to the previous assessments, the authorities have improved data coverage, in particular as regards the provision of up-to-date information and a more structured analysis of public debt. Significant effort was made in setting out more clearly the medium-term debt management strategy, and supporting it with a robust sensitivity analysis of the borrowing alternatives. The programme also presents for the first time the calculations of potential output growth and structural fiscal balances, which allows a better insight into the interaction between cyclical conditions and fiscal developments for the Serbian economy. On the other hand, the three-year fiscal programming based on the medium-term expenditure framework remains to be fully reflected in the programme. The programme would largely benefit from specifying the adopted/planned revenue and expenditure measures together with their expected fiscal effects for each year over the programme period.

As regards the structural reforms framework, the programme fails to provide fully convincing action plans as regards the medium-term policy priorities. Roadmaps and timetables for the implementation of the most important reform measures over the medium-term, as well as full-fledged assessments of their budgetary impacts, are largely missing. The programme announces as a general guideline a move towards a performance-based financing in the provision of public services, but does not provide the implementation schedules for the planned adjustments. By spelling out concrete roadmaps and timetables, the authorities will improve credibility of their medium-term economic and fiscal strategy, geared towards enhancing growth, competitiveness and employment.

7 TURKEY

7.1 EXECUTIVE SUMMARY

Turkey submitted its eleventh Pre-accession Economic Programme in January 2012. The programme covers the period 2012-2014 and represents an update of the previous years' submission. It builds on earlier policy documents, such as the Medium Term Economic Programme adopted in autumn 2011, including its Medium Term Fiscal Framework. The document largely complies with the content, form and data requirements. The Commission's requests for additional analyses made in mid-2011 and the Commission's suggestions in last years' PEP assessment have not been taken on board. In particular, the specific information related to key macroeconomic imbalances and the sustainability of the external accounts as well as an assessment of the main structural growth bottlenecks would have been highly relevant and useful under the current circumstances. The PEP is supported by a sufficiently comprehensive and broadly consistent macroeconomic framework, which appear however somewhat optimistic, in particular with respect to the balance-of-payments and inflation scenarios.

Similar to last year's PEP, the programme's key objectives are to strengthen macro economic stability so as to ensure sustainable growth leading to convergence of per capita income towards the EU-average. To this end, the monetary and fiscal policy mix aims at continued fiscal prudence while structural reforms are to enhance the role of the private sector, and to improve financial sector intermediation and increase the value of human capital. However, the recent track record and the implementation of structural reforms have been slow and progress has been uneven. The PEP did not sufficiently elaborate the structural reform strategy in 2012-2014.

As recently evidenced by the global financial crisis and the risks of sovereign debt crisis in the euro area, the Turkish economy has increased its resilience. In 2010 and 2011, real GDP growth amounted to respectively 9% and 8.5%. The general government budget deficit has fallen from 3.7% in 2010 to about 1.5% in 2011 and the gross debt stock to GDP ratio is estimated to have retreated to 39% by the end of 2011.The unemployment rate declined by one percentage point to 9% in December 2011. However, the current account deficit edged up rapidly from 6.4% of GDP in 2010 to about 10% of GDP in 2011, in tandem with the widening trade deficit. In addition, headline inflation started to rise markedly in the second half of 2011, from about 6% in mid-2011 to 10% by the end of the year.

Over 2012-2014, the programme estimates that the Turkish economy will grow at rates around potential, i.e. at around 4-5%. Growth would become more balanced, albeit still driven by gross fixed capital formation (7% annually on average) and to a lesser extent private consumption (3.5%). Exports of goods and services are projected to accelerate gradually from about 5% annually in 2012 to 8.5% in 2014, compared with a major slowdown of imports in 2012 (from 10.8% the previous year to 4.3%) and a rather stable increase in the following years of over 6%. The macroeconomic scenario tends, however, to ignore some major risks such as the widening of external imbalances and the intensification of inflationary pressures. It foresees a reduction of the current account deficit from 9.4% in 2011 to 7% of GDP by 2014. Over the past two years, not only has the current account deficit rapidly and substantially increased but its significant

narrowing seems unlikely. Although weaker domestic demand may reduce imports somewhat, energy prices remain high and the outlook for Turkish exports remains weak given the mild recession forecasted in the euro area in 2012, the destination of about 45% of the country's exports. Furthermore, the quality of the current account financing has deteriorated, increasingly shifting towards potentially volatile short-term capital. These developments, together with mounting inflationary pressures, may pose an additional threat to internal and external stability in 2012-2014 and may call for a more restrictive monetary and fiscal policy mix than what is presented. In particular the complexity of the present monetary policy stance has been subject to major criticism and would therefore deserve some more explanation. In sum, the PEP would greatly benefit from a more in-depth analysis and quantification of risks.

In 2011, the general government budget deficit narrowed to about 1.4% of GDP- compared with 1% in the PEP - from 3.5% in 2010, thereby performing better than the 2.1% deficit envisaged in the budget, mainly due to strong growth which resulted in higher budget revenues than originally anticipated, and the proceeds of a major tax restructuring scheme (about 1% of GDP). The PEP's medium-term fiscal programme envisages an improvement of the consolidated general government balance, from a projected deficit of 1.0% of GDP in 2011 to 0.8% in 2012 and 2013 and 0.4% in 2014, in part due to lower interest payments in 2013 and 2014. The public debt to GDP ratio is anticipated to fall gradually from 39.8% of GDP in 2011 to 32% by 2014. In the light of the programme's growth projections, the fiscal policy objectives appear realistic, albeit not very ambitious. As in previous years, the document does not sufficiently elaborate on the policy measures which could support achieving the fiscal targets and therefore lacks some transparency. Turkey has accomplished a remarkable effort of fiscal consolidation in previous years, but ensuring a high-quality fiscal adjustment will be a key challenge in the coming years. In addition, the Turkish government has, on several occasions, turned to ad-hoc measures to achieve its fiscal targets. To prevent this in the future, a stronger fiscal anchor and an acceleration of key structural reforms would be highly beneficial, in particular given Turkey's dependence of foreign savings.

Like last year, the programme's structural and institutional reform agenda, which appears fragmented and covers a broad range of issues, is insufficiently linked to the fiscal scenario, and only partly aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership. The Turkish economy has benefited from reforms in areas such as banking, energy and education. However, reforms still have to be pursued in several important areas, such as labour markets and the investment climate. The programme would benefit from a more thorough analysis of the key structural weaknesses and bottlenecks to growth and an elaboration of a comprehensive strategy including precise measures on future reforms and a timeline for their implementation.

Comparison of key macroeconomic and budgetary projections

		2010	2011	2012	2013	2014
Real GDP growth (% change)	COM	9.0	7.5	3.0	4.1	n.a.
	PEP 2012	**9.0**	**7.5**	**4.0**	**5.0**	**5.0**
Consumer price inflation (%)	COM	8.6	8.5	7.2	7.2	n.a.
	PEP 2012	**8.6**	**5.9**	**6.6**	**5.0**	**4.9**
General government balance (% of GDP)	COM	-3.5	-2.4	-2.4	-2.5	n.a.
	PEP 2012	**-2.9**	**-1.0**	**-0.8**	**-0.8**	**-0.4**
Primary balance (% of GDP)	COM	1.4	2.4	2.7	2.8	n.a.
	PEP 2012	**1.6**	**2.5**	**2.8**	**2.7**	**2.9**
Government gross debt (% of GDP)	COM	43.2	39.7	38.7	37.8	n.a.
	PEP 2012	**42.2**	**39.8**	**37.0**	**35.0**	**32.0**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission autumn 2011 forecast

7.2 INTRODUCTION

Turkey's eleventh Pre-Accession Economic Programme (PEP 2012-2014), submitted in January 2012, is consistent with other economic policy documents, such as the ninth National Development Plan (2007-2013). It presents a rather optimistic medium term macroeconomic and fiscal framework prepared on the basis of the Medium Term Programme (MTP, 2012-2014) published in October 2011 and elaborated upon already in summer 2011. The programme largely complies with the requested standards in terms of content, form and data and demonstrates a high degree of familiarity with the technical tools and analytical requirements of this exercise. At the same time, some updating in the light of recent developments and further analysis in some key areas would be welcome. In particular, the programme does not address a request by the Commission to present an in-depth analysis on the external sustainability and competiveness issues of the Turkish economy as well as on the key structural growth bottlenecks. A further elaboration of the fiscal and structural strategies would enhance its role in guiding economic policy.

Similar to previous year's PEP, the programme’s key objectives are to create employment, sustain fiscal discipline, increase domestic savings, and reduce the current account deficit in order to strengthen macroeconomic stability and to ensure a more stable growth path and increase welfare.

7.3 KEY CHALLENGES

The PEP has been prepared in an environment of high uncertainties and risks in the global economy. Turkey's economic growth performance over the past two years was remarkable. However, in part due to strong economic growth in 2011 - on the back of robust domestic demand and higher imports in combination with high commodity prices – pressures have accumulated. In particular, the current account deficit has increased dramatically, and inflationary pressures have intensified. Under such circumstances, the main challenge for Turkey is to design and implement a balanced monetary and fiscal policy mix which preserves macroeconomic stability and ensures a sustainable growth path conducive to labour market improvements. The 2011 Progress Report had already emphasised that macroeconomic stability still remained fragile and needed to be carefully monitored, and that in particular a stronger fiscal anchor and a more transparent monetary policy may be beneficial. Key structural reform challenges persist, including

the need to boost employment levels and reduce labour market rigidities, to implement tax reforms and advance on privatisation in the energy and financial sectors.

7.4 RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

7.4.1 Recent macroeconomic developments

The strong economic recovery continued in 2011, supported by stronger credit growth and higher employment. The pace of GDP growth slowed slightly to 8.5% year-on- year from 9% in 2010, but exceeded the PEP's forecast of 7.5%. The robust overall growth reflected more buoyant private and public consumption than anticipated in the PEP, as these expenditure categories grew by respectively 8% and 4.5%. However, gross fixed capital formation growth remained the driving force behind this robust growth, and rose by about 18% in 2011. Primarily due to a weaker Turkish lira, export competitiveness has improved and exports of goods and services outpaced imports as from mid-2011. In tandem with the robust economic expansion, unemployment fell by over 1 percentage point on an annual basis, and stood at 9% as of December 2011. As a key concern, youth unemployment remains at high levels of about 18%. Substantial gender disparities in labour markets persist and female employment remains particularly low, at about 20%, compared with over 60% for men.

The current account deficit has been ballooning faster than foreseen in the PEP, in tandem with a large and widening merchandise trade deficit, driven in particular by the impact of strong domestic demand and higher oil prices. Turkey's current-account deficit practically doubled in one year and reached 10% of GDP in 2011.

A weaker lira, base effects from unprocessed food prices and indirect tax increases are putting strong upward pressure on consumer price inflation, which went up from about 6% in mid-2011 to 10.4% in the year to December 2011. This compares with an official target of 5.5% for the end of 2011, with a tolerance band of ±2 percentage points, and 5.9% in the PEP. In spite of the rising inflation, the central bank kept its main policy rate unchanged at 5.75% citing the risk of recession owing to the problems of the world economy. At the same time, the bank left the overnight borrowing and lending rates at 5% and 12.5%, thereby maintaining the wide corridor established in October. To stem the lira's fall of about 20% vis-à-vis the euro in 2011, the central bank has opted for hefty foreign exchange interventions. As a result, total gold and foreign exchange reserves fell to €67bn, the lowest level since early 2011, but still significantly higher than the €55bn early 2010. Thanks primarily to cyclical factors, Turkey reports strong fiscal results, with the overall budget balance improving. Turkey's general government budget recorded a deficit of 1.4% of GDP in 2011, compared to 3.6% a year earlier. Since 2009, public debt fell significantly and amounted by the end of 2011 to less than 40% of GDP.

7.4.2 Medium-term macroeconomic scenario

The PEP 2012-2014 presents a rather optimistic growth scenario (in particular in 2012) with a soft landing of the Turkish economy, with growth being driven by private consumption, exports and chiefly investment. The external assumptions are based on the Commission's autumn forecast and on autumn IMF and OECD forecasts. On this basis, the PEP expects the euro area's GDP to rise by 1.1% in 2012, 1.5% in 2013, and 1.7% in

2014. Since then, conditions have significantly worsened, and as of February 2012, the Commission forecasts a growth decline of 0.3% in 2012. As the euro zone absorbs over 45% of Turkey's exports, this may have a major impact on Turkish trade and growth at large.

Comparison of macroeconomic developments and forecasts

	2010		**2011**		**2012**		**2013**		**2014**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	9.0	**9.0**	7.5	**7.5**	3.0	**4.0**	4.1	**5.0**	n.a.	**5.0**
Contributions:										
- Final domestic demand	10.9	**10.9**	11.5	**9.6**	1.3	**4.1**	2.5	**5.2**	n.a.	**5.0**
- Change in inventories	2.4	**2.4**	-0.1	**0.2**	-0.1	**0.1**	0.0	**-0.1**	n.a.	**-0.1**
- External balance of goods and services	-4.4	**-4.4**	-4.1	**-2.3**	1.6	**-0.1**	1.3	**-0.1**	n.a.	**0.1**
Employment (% change)	6.2	**6.2**	1.6	**5.9**	1.0	**1.4**	1.4	**2.0**	n.a.	**2.1**
Unemployment rate (%)	11.9	**11.9**	10.2	**10.5**	10.3	**10.4**	10.4	**10.2**	n.a.	**9.9**
GDP deflator (% change)	6.3	**6.3**	7.7	**8.0**	6.0	**7.0**	5.2	**5.0**	n.a.	**5.0**
CPI inflation (%)	8.6	**8.6**	8.5	**5.9**	7.2	**6.6**	7.2	**5.0**	n.a.	**4.9**
Current account balance (% of GDP)	-6.6	**-6.4**	-9.8	**-9.4**	-8.8	**-8.0**	-8.6	**-7.5**	n.a.	**-7.0**

Sources: Pre-Accession Economic Programme (PEP) 2012, Commission Autumn 2011 forecast (COM)

Real sector

The real sector scenario used in the programme is somewhat more optimistic than the Commission autumn 2011 forecast. The PEP projects a significant growth slowdown as from mid-2011. Real growth is projected to average 4-5% over the medium-term, boosted by robust private sector demand, primarily investment and higher exports. Private consumption is foreseen to grow by about 3% on average over the programme horizon, supported by rising incomes and employment. Although its growth rate is more than halved on average over the period 2012-2014, as compared to 2011, investment remains the main driver of growth, increasing by 6.5% in 2012 and accelerating to almost 9% in 2013-2014. Growth in exports is expected to gradually accelerate from 4.7% in 2012 to 8.5% in 2014, while the major slowdown in domestic demand, expected in 2012 will be driving down imports growth to 4.3%. Imports are thereafter projected to rise by 6.2% in 2013 and 6.7% in 2014. As a result, the external trade deficit is set to decrease from 11% of GDP in 2011 to 9.3% of GDP in 2014.

The PEP growth scenario appears slightly optimistic, and is subject to major downside risks, some of which being briefly listed in the PEP and mainly related to slower than projected growth of Turkey's export markets. Based on four methods used to estimate potential output, the programme considers that the output gap will be gradually narrowing as actual output will gradually move towards potential by 2014. There are upside risks to this growth pattern given the much better than anticipated growth performance in 2011 (real growth of 8.5% compared with 7.5% in the PEP). Therefore overheating may occur much earlier. Downside risks include lower global growth, higher commodity prices and slowing capital inflows, which may stem from interest rates hikes in advanced economies, or an increased risk aversion towards emerging markets in general, or towards Turkey specifically.]

Regarding the contribution of the various production factors to growth, Turkey's output will be mainly driven, as in the past, by capital deepening, and to a much lesser extent by employment growth while the increase in TFP is expected to be limited, and less than 1%. Throughout the programme period, the value added generated in the industrial sector is expected to increase by an average 5% annually. By 2014, the services sector, the industry and agriculture would represent respectively 64%, 27% and 9% of the overall value added in the Turkish economy.

Inflation

Base effects, a weaker lira and tax hikes imply that Turkey's inflation has yet to peak and will remain above the central bank's comfort zone 5% +/-2% for the bulk of 2012. Against this background, the inflationary outlook projected in the PEP appears benign. It expects inflation to decline below the 5.0% mark by 2013, which is notably below market expectations (currently about 7% for end-2012). The central bank's unconventional monetary policy has not yet succeeded in curbing above-target rate of inflation, in sufficiently restoring policy credibility and, along with fiscal measures, in helping rein in the widening current account deficit. At the end of 2011, the annual rate of headline and core CPI stood at 10% and 8%, respectively, significantly above the 5% year-end target of the central bank. Inflationary pressures have risen since mid-2011 due to pass-trough effects stemming from a TRL trade weighted depreciation of about 20%, as well as high food prices and oil and other commodity prices. Going forward, stronger inflationary pressures could also result from stronger wage increases, if public sector pay increases continue to spill over to the private sector. Moreover, necessary alignments of indirect taxes (e.g. excises) as well as further adjustments of administrative prices or pressures stemming from growth above potential in 2010 and 2011 could add to prices increases. Considering that Turkish price stability is challenged by structural issues that render it vulnerable to external and supply-side shocks, coupled with a compressing output gap, bringing inflation sustainably down would likely require structural efforts and a much tighter mix of monetary, fiscal, and prudential policies. At the same time it is reasonable to assume that a more conventional and stability-oriented monetary policy framework may help preventing a significant re-acceleration of inflation in the medium-term.

Monetary and exchange rate policy

Growing inflationary pressures, and high credit growth (about 25% annually) fuelling domestic demand and imports, and culminating in a growing current-account deficit continued to make the central bank of Turkey's task of setting monetary policy highly challenging. The key objective of monetary policy is to ensure price stability, or – in other words – to support the disinflation process. The 2012 PEP presents a short description of the framework of monetary and exchange rate policy. As in previous years, Turkey's central bank will target inflation in the 2012-2014 period. By the end of 2012, the inflation target would have fallen to 5% from 5.5% in 2010. In 2013, the inflation target amounts to 5%, while the 2014 target has not yet been decided. These targets remained unchanged from the 2011 PEP. The ultimate, long-term target is to decrease inflation rate to levels complying with the Maastricht criteria.

Besides enhancing the overall transparency and predictability, a more credible management of expectations and more confidence are seen as key factors aiming at further improving monetary transmission. The free floating exchange rate regime remains in place. The interventions made so far, and in particular at the end of 2011, aimed at smoothening excessive exchange rate volatility. More transparency in the central bank's operational targets may be needed to re-establish credibility of its inflation target. The bank uses a rather complex policy mix, and keeps the policy rate low, while utilizing the wide interest rate corridor as its main policy tool, with the bank borrowing costs fluctuating between the repo rate and the lending rate (5.75-11.5% range). Some, albeit minor success could be observed in the first two months of 2012, as the pace of bank lending has fallen in combination with an increase in the nominal exchange rate of the lira.

External sector

In 2011, Turkey's current account balance has deteriorated dramatically as imports rose proportionally much faster than exports. For the programme period, a decline of the current account deficit is expected. The underpinning scenario comprises a rather optimistic evolution of exports (gradually up from 5% to 8.5% growth over 2012-2014 as compared to 3% in 2010-2011), due to accelerating growth in main partners and thus in external demand, which seems rather unlikely. At the same time, the pace of merchandise imports seems very subdued against the foreseen - rather benign - fall of domestic demand, and the continuously high energy prices are likely to affect overall import prices - and import values - significantly. The scenario is also - albeit to a lesser extent- upbeat on tourism revenues. The expected volume of workers remittances is forecasted to stabilize around USD 1 billion. As a result, the current account deficit is expected to decrease gradually from 9.4% of GDP in 2011 to 7% by 2014. This appears optimistic as the outturn for 2010 was 10% of GDP and pressures have not been abating very much. The programme does not anticipate any difficulties in financing the current account deficit, despite proportionally, much more volatile capital inflows (mainly portfolio, bank credits and an observed tripling of errors and omissions) than in 2010.

Furthermore, the PEP expects some rebalancing between FDI and portfolio investment. FDI is projected to increase gradually from USD 11.4 billion in 2011 to USD 13.2 billion by 2014, while portfolio investment is forecasted to fall by one third - from USD 19.7 billion in 2011 to USD 13.3 billion in 2014. No alternative scenarios are included on energy imports. Given the high sensitivity of the Turkish current account to oil prices, the programme would have benefited from an in-depth analysis of the effect of a shift in oil demand combined with energy price volatility. In addition, and like in previous years, the programme does not include a scenario whereby the TRL real exchange rate shows significant instability relative to the baseline scenario and its effect on the current account. Finally, the PEP does not sufficiently comply with the Commission's request to present an in-depth analysis of external sustainability based on a set of relevant indicators.

Financial sector

As in previous years, the PEP presents a brief overview of the recent developments in the financial sector. However, it lacks an in-depth assessment of the sector's financial

stability, in particular as the central bank's policy to curb the very high credit growth, and the overall volatility in financial and money markets had significant consequences for the sector's profitability and soundness. More specifically, public banks and participation banks seem not to have adapted as well as private banks to the changes in market conditions.

Macro-prudential measures enacted in mid-2011 by the Turkish banking regulator have led to a sharp rise in lending rates and there are recent signs of slowing credit growth. The banking regulator's discretionary, targeted macro-prudential measures appear to be a step in the right direction. The increase in provisioning, higher risk-weights and reserves placed on new consumer loans is increasing the cost of lending and borrowing, and slows household credit growth. However, the experience of other countries that used similar measures point to mixed results. While the measures often slow the pace of credit growth, it remains challenging for regulators to determine the “right” level for loan-to-value ratios, provisioning and/or risk-weights needed to curb credit expansion and ensure financial stability, and soundness of the sector.

Main risks and challenges

The PEP focuses on preserving macroeconomic stability and sustainable growth, maintaining price stability and sound public finances, improving competitiveness, and enhancing the labour market performance. It mentions as sources of risks the recent developments in the world economy, including the sovereign debt crisis and problems in Greece, Portugal, Spain and Italy, as well as a potential oil price shock.

However, the programme only very briefly touches upon these risks, all considered to stem from the external environment. It would benefit from a more systematic analysis of risks, possibly under the form of alternative macro scenarios.

The main risks to the macroeconomic framework are also clearly associated with the very strong recent growth and the major imbalances emerging in the Turkish economy. Overheating pressures could emerge earlier and more rapidly than suggested by various methods to measure the output gap. Due to the strong economic growth - on the back of robust domestic demand and higher imports in combination with higher commodity prices - the current account deficit has increased significantly, and inflationary pressures have intensified. At the same time, the quality of the external financing has deteriorated which could also imply more elevated refinancing risks forwarding the future. Under those circumstances, the main challenge for Turkey is how to design and implement a more balanced monetary and fiscal policy mix.

7.5 PUBLIC FINANCE

The fiscal framework of the PEP 2012-2014 is presented as an integral part of - and supportive to - the overall medium-term economic policy framework. The overall objective of Turkey’s fiscal policy continues to be the establishment of a sustainable growth environment while at the same time supporting disinflation. The gradual reduction of the budget deficit is the main fiscal tool in this respect, contributing to ensuring debt sustainability. The programme would have gained from a more in-depth discussion of the policies and tools to achieve the announced fiscal targets.

Main revenue-related measures are an improvement of efficiency in tax collection and a broadening of the tax base. On the expenditure side, emphasis is put on reducing the social security (mainly health) deficits. Like in previous years, no quantitative estimates of the budgetary effects of the individual measures are given.

The 2012 programme comprises cyclically adjusted budgetary balances. It benefits from some clarifications on the methodology used in the individual sections. In particular, it includes a box to explain the adjustments made to consolidate general government and ESA95 based data.

7.5.1 Budget implementation in 2011

Turkey does not publish consolidated general government budget reports on a regular basis. Furthermore, the 2012 PEP does not describe any budget execution developments in 2011 which is a major shortcoming. Other official sources suggest that budget developments throughout 2011 were strong, which helped the current account balance in terms of public savings, and also limited the burden on interest rates, already under pressure from global turbulence and the central bank's monetary policy. Turkey's central government budget recorded a TRY17.9 billion deficit in 2011 (1.4% of estimated GDP), thanks to strong revenue growth, a moderate increase in expenditures and low interest expenditures. The budget balance was better than Turkey's medium-term fiscal plan forecast of 1.7% of GDP and the budget forecast of 2.8% of GDP which did not include amnesty related revenues amounting to 1% of GDP.

Composition of the budgetary adjustment (% of GDP)

	2010	2011	2012	2013	2014	Change: 2011-14
Revenues	35.4	36.4	36.8	36.5	36.1	-0.3
- Taxes and social security contributions	27.7	29.2	29.2	29.2	29.0	-0.2
- Other (residual)	7.7	7.2	7.6	7.3	7.1	-0.1
Expenditure	38.3	37.4	37.6	37.3	36.5	-0.9
- Primary expenditure	33.8	33.9	34.0	33.8	33.2	-0.7
of which:						
Gross fixed capital formation	3.4	3.6	3.3	3.4	3.3	-0.3
Consumption	17.0	16.9	16.7	16.5	16.0	-0.9
Transfers & subsidies	6.5	5.8	6.1	6.1	5.9	0.1
Other (residual)	6.9	7.6	7.9	7.8	8.0	0.4
- Interest payments	4.5	3.5	3.6	3.5	3.3	-0.2
Budget balance	-2.9	-1.0	-0.8	-0.8	-0.4	0.6
- Cyclically adjusted	-2.3	-2.0	-1.8	-1.6	-1.2	0.8
Primary balance	1.6	2.5	2.8	2.7	2.9	0.4
Gross debt level	42.2	39.8	37.0	35.0	32.0	-7.8

Sources: Pre-Accession Economic Programme (PEP) 2012, ECFIN calculations

7.5.2 Near-term and medium-term budget strategy

The PEP's fiscal scenario contains a relatively detailed presentation of the operations of the central government but fails to present sufficient information about the general

government. Fiscal projections –even for 2011– are based on the medium term fiscal framework adopted in November 2011.

For the year 2012 and in line with the budget framework adopted in late 2011, the programme projects an increase in spending of 0.2 percentage points of GDP in tandem with increasing revenues (by 0.4 pp of GDP). Accordingly, the general government deficit will decrease by 0.2 percentage points to 0.8% of GDP. The 0.4% increase in the share of revenue to GDP appears to be optimistic and inconsistent with the projected fall in GDP growth, assuming that the tax elasticity does not improve in the short term. The increase of the expenditure-to-GDP ratio in 2012 is largely driven by higher current transfers (up by 0.8 percentage point), which appears to be in part linked to the increasing social spending commitments and social security deficits while the share of GFCF declines.

In 2013 and 2014, several expenditure categories (interest payments, current expenditure, as well as transfers) are programmed to be somewhat reduced as a share of GDP and so is the revenue-to-GDP ratio. The slight decline in interest payments does not appear to be entirely consistent with current expectations for interest hikes by the central bank over the medium-term.

In 2013, the general government deficit is projected to remain at 0.8% of GDP, before declining to 0.4% of GDP by 2014. Although appropriate, the programme itself does not elaborate in more detail on the spending adjustment.

Risks

Fiscal risks are clearly related to the downside risks to growth assumptions of the programme, in particular in 2012. A stronger cyclical downturn is likely to worsen the fiscal balance. In addition to lower growth effects, the revenue base is likely to decrease especially for indirect taxes, as a result of the forecasted disinflation process. Altogether, a stronger decline in fiscal revenues than projected in the PEP could materialise. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings. This refers in particular to current spending commitments and social transfers. The authorities may also be confronted with continued spending pressures, for example in the public wage bill. Finally, the current volatility and sovereign debt crisis in the euro area may lead to pressures to increase short-term discretionary spending to counterbalance the negative effects on growth and employment. The resulting combined effect of markedly lower fiscal revenues and pressures for higher current spending would undermine the envisaged fiscal path. Therefore, an appropriate fiscal response under current circumstances would require both bold fiscal measures to reign in current spending and the introduction of a binding fiscal rule.

Structural balance (cyclical component of deficit, one-off measures and temporary measures, fiscal stance)

The PEP 2012-2014 provides an overview on the cyclical position of the economy and the impact of fiscal policy, using the same methodology in estimating cyclically adjusted primary balances as in last year's submission. On this basis, actual output would exceed its potential in 2014, the negative gap being gradually reduced over the 2012-2013 period. As of 2011, the structural and actual primary budget balances start to converge

and the actual primary budget surplus increases. It is estimated that the structural primary budget surplus which was around 1.4% of GDP in 2011, will gradually increase to 2.1% by 2014. On this basis, the PEP concludes that fiscal policy is broadly neutral in 2011-2014. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with caution.

Budgetary implications of "major structural reforms"

The programme provides only piecemeal information and is largely backward looking about the budgetary impact of structural reforms. Some information is provided on reforms in regional development, healthcare, energy and transportation. At the same time, the programme is silent on various other reforms, which could bring about a cost, e.g. the increase in the number of ministries decided in mid-2011 and implemented in September.

General government debt

The PEP 2012-2014 projects a baseline scenario of a gradual and significant decrease of general government debt from 39.8% of GDP in 2012 to 32% of GDP in 2014. Projections on the decomposition of changes in the debt ratio appear sufficiently comprehensive and consistent with the macroeconomic and fiscal assumptions. However, the huge Stock Flow Adjustment in 2011 raises questions. It remains unclear where this large contribution is coming from. Furthermore, the PEP could touch on the liabilities linked to the recent establishment of various Public Private Partnerships (PPP), in particular in the health sector. The Turkish authorities admit that these liabilities are significant, and should be taken into account into the risk assessments regarding Turkish public finances.

Composition of changes in the debt ratio (% of GDP)

	2010	2011	2012	2013	2014
Gross debt ratio [1]	42.2	39.8	37.0	35.0	32.0
Change in the ratio		-2.4	-2.8	-2.0	-3.0
Contributions [2]:					
1. Primary balance		-2.5	-2.8	-2.7	-2.9
2. "Snow-ball" effect		-2.9	-0.6	-0.1	0.0
Of which:					
Interest expenditure		3.5	3.6	3.5	3.3
Growth effect		-6.4	-4.2	-3.6	-3.3
3. Stock-flow adjustment		3.0	0.6	0.8	-0.1

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual.

Source: Pre-Accession Economic Programme(PEP); Commission services' calculations

7.5.3 Sensitivity analysis and comparison with previous PEP

The public debt sensitivity analysis presented in the PEP shows that the public debt ratio could increase by about 5 percentage points more by 2014 under a combined shock scenario, i.e. when growth falls by 2%, the TRL depreciates by 10% and real interest rates increase by 500 base points. The analysis undertaken in the PEP is useful and confirms the need for continued fiscal discipline in order to ensure public debt sustainability. However, the current uncertainties regarding growth prospects may justify some analysis on the sensitivity of public debt to a larger growth contraction in the next programmes, and to subsequently worse fiscal balance outcomes. A similar comparison was presented in last year's PEP.

7.5.4 Quality of public finance and institutional features

As in previous years, the PEP 2012-2014 refers in a very general way to recent and ongoing institutional changes and policies which are deemed to improve the quality of public finances over the medium term. It emphasises improvements in budget management, revenue collection and expenditure control and a new legal framework for public-private partnerships. The programme foresees that, in order to reduce the need for ad-hoc measures to reach fiscal targets, efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions will be continued. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge in the coming years. Indeed, fiscal pressures might emerge over the medium term, either as a result of past policy commitments, for example in education and access to the universal health insurance, or owing to a still pending reform agenda.

As public expenditures are already relatively high there is limited scope for Turkey to increase expenditure in order to meet pressing convergence challenges. Expenditure will also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Fiscal policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas where it appears to be oversized in comparison with other similar countries. At the same time, additional reforms will need to be implemented with the aim of improving the efficiency of expenditure programmes in areas where expenditure pressures are being increasingly felt, such as health care, education, and social protection. Reforms focused on the modernization of civil service pay and employment system and the rationalization of the investment programme, would also help contain pressures on the wage bill as well as restrain capital transfers and thus contribute to better control public expenditure across functional areas. While efficiency considerations are considered to be the main priority in public expenditure policies, the basic objective of the tax policies to be implemented is to contribute to supporting growth and employment in accordance with macroeconomic policies, reducing informality in the economy, and creating a tax system that is simpler, fairer and with wider base. Fight against the informal economy has been stepped up in accordance with the strategy established thanks to enhanced inter-institutional cooperation.

7.5.5 *Sustainability of public finance*

Like in previous years, the 2012 PEP does not contain a separate section on the long-term sustainability of public finances. The lack of long-term demographic and macroeconomic projections is a shortcoming. Turkey's situation differs dramatically from that of EU Member States. With its very young population (the average age is just 29), falling birth rates, and significant in- and outward migration, some more in-depth analysis would be crucial in the context of the PEP. The future costs of the pension and health-care systems should be monitored very carefully.

7.6 STRUCTURAL REFORMS

7.6.1 *Obstacles to growth and structural reform agenda*

The PEP does not comply with the Commission's request to present an assessment of structural obstacles to growth. . Although Turkey has made some efforts in recent years, more could be done to improve the business and investment climate, to build additional capacity of skilled labour, and increase domestic savings so as to be less dependent on foreign capital. Conversely, the general aim of the structural reform agenda presented in the PEP remains to increase the efficiency in the private sector and the public administration and to support the strengthening of market forces. Overall, the structural reform agenda should be broadly supportive of further enhancement of Turkey's capacity to cope with competitive pressures and market forces within the EU. More emphasis should be put on labour market reforms, to support job creation during the economic transformation process. The outlined structural reform agenda represents a mere continuation of the plans put in place over the last years.

Net direct budgetary impact of key reform commitments (in EUR million)

	2012	2013	2014
Labour market	0.0	-	-
Agriculture and rural sector	-0.2	-	-
Regional development (GAP)	-2.2	-2.1	-2.1
Social security	0.7	0.9	0.9
Transportation	-0.1	-0.2	-0.2
Energy	-2.0	-	-
Other reforms (public administration, knowledge-based society, judiciary, environment, public procurement etc)	-	-	-
Total impact on the budget	-3.7	-1.4	-5.2
Total impact on the budget (in % of GDP)	-0.6	-0.2	-0.7

Source: 2012 Pre-accession Economic Programme (PEP), own calculations

7.6.2 *Key areas of structural reform*

Overall, the programme's objectives are broadly appropriate. Some attention is given to stimulating innovation, job creation, fostering regional development, transportation and reforms in the energy sector. However, the measures presented mainly refer to the recent past or at most 2012 and indications on major future measures are scarce and

insufficiently developed. In addition, the timeline, sequencing and links between different measures and reforms are either lacking or not sufficiently elaborated upon.

Product and capital markets

The PEP 2012 sets out developments in key areas such as the strengthening of competition policy, privatisation, improving the investment climate, agriculture and SME development. It also envisages a continuation of measures aimed at strengthening the legal and institutional framework and a further harmonisation with EU requirements, which is welcome. The PEP does not always mentions delays that have been encountered in certain sectors compared to what was envisaged in the previous PEP. Privatisation efforts are to continue during the programme period, for example in banks, energy, ports and activities related to the tobacco industry. There is a risk that further delays will occur during the programme period compared to the outlined plans, as after years of intensive privatisation, the remaining portfolio of state-owned enterprises is likely to be more challenging to privatise: it is concentrated in areas where privatisation can be seen as more sensitive. Concerning the area of business law and policies, major progress has been achieved as a new commercial code has been adopted that should improve transparency and access to finance.

In the field of banking, the privatisation of the largest state bank, Ziraat Bank, has once more been delayed but past and planned measures are supportive of the overall positive developments in this so far well performing sector. Despite the demonstrated improved resilience of the Turkish banking sector to severe market fluctuations, also thanks to a number of specific supervisory measures, a continued strengthening of supervision will be important to further decrease risks in particular in the context of the still rapidly growing banking operations. Concerning capital markets, a new capital markets law is under preparation (to be adopted in autumn 2012) and is seen to create a more stable and efficient market in line with the EU acquis. The programme gives a thorough overview of recent and planned measures aimed at aligning the financial sector legislation and in particular prudential regulations with EU requirements. The programme could have discussed in more detail the new challenges for domestic financial and capital markets stemming from falling profitability as funding has become more expensive along with the increase in commercial banks reserve requirement ratios. This appears to be particularly relevant for the public and participation banks.

Labour market

The programme is a mere update from last year's. It points to the main problems and challenges in the Turkish labour market, such as the very low participation rates particularly of women, the high proportion of people employed in, and the low productivity of the agricultural sector and the growing young population. It also shows that there has been a significant improvement in bringing down the unemployment rate since the last PEP. The programme strongly emphasises the link between the labour market and the education sector and the need to reduce the skills mismatch between labour demand and supply. The overall educational attainment levels of the labour force are still low, despite improvements during the past years. Looking forward over the programme period, the PEP is quite vague on concrete measures that will be taken to further improve the educational standards. There is no information about the planned scope for active labour market policies or resources which will be put aside for this purpose.

The PEP does not refer to the National Employment Strategy under preparation, notably to the application of the flexicurity principle. This would deserve further elaboration. Overall, it puts only limited focus on the role of labour market regulations and the informal sector in addressing the existing problems. The proposed new severance pay system should be explained. Non-wage labour costs remain relatively high and the regulations of the labour market rigid. Tackling these issues in a more systematic way would help address the identified challenges in the labour market and support the creation of jobs in the challenging transformation period ahead. The programme proposes to reduce the cost of employment, but details about the scope and timing of measures remain unclear.

Other reform areas

The PEP outlines a wide range of areas where reform efforts have been ongoing and are foreseen to continue over the programme period. Further efforts have been made to improve public financial management, which has yielded positive results, for example as regards the budgeting process and transparency. However, the PEP does not outline any further steps to be taken in this area. Local governments' reform aims at strengthening their role and abilities to perform the needed services. Legal reforms have proceeded, but the PEP acknowledges that there are deficiencies in the capacity to implement laws at the local level.

Further social security reforms are very important, particularly given that the sizeable deficits in the social security contributions strongly contribute to Turkey's fiscal imbalances.

7.7 OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The recent macroeconomic performance (higher growth, larger imbalances) is not adequately described and some relevant information available at the time of submission has not been included. The medium-term scenario is rather optimistic, and some key challenges are not properly assessed, for example the external sustainability including the large energy dependence of the Turkish economy in a context of high oil prices and risks of a much higher current account deficit than anticipated, or the rapidly increasing inflationary pressures observed in the second half of 2011. The framework is drawn from the MTP which was elaborated in mid-2011 and published in November 2011.The lack of updating hampers the analysis and leads to some inconsistencies compared with recent developments throughout the document.

Fiscal framework

Turkey does not regularly publish consolidated general government accounts. In addition, the ESA95 alignment has not been improved in the 2011 fiscal notification. The PEP lacks 2011 data on budget execution, and does not mention any detailed and concrete fiscal measures conducive to achieving the planned reduction in the spending ratio. Future PEP would benefit from more complete data (e.g. on general government expenditure by function, long term fiscal projections). A longer term analysis of public finance sustainability could be added to the baseline fiscal programme to better

understand risks to the scenario, in particular the ones stemming from the demographic and labour situation in Turkey.

Structural reforms

The PEP does not indicate bottlenecks to growth as requested by the Commission in the PEP outline. As in previous years, the objectives that are identified in the programme are in general supportive to the fulfilment of the Copenhagen economic criteria, as they aim at making some key parts of the Turkish economy more competitive, and the priorities appear right. However, concrete implementation measures and timetables remain vague and their fiscal impact is not always well elaborated. This part of the PEP would definitely benefit from a more strategic assessment, which focuses on the medium-term.

Annex: Structural indicators

	Turkey					EU 27				
	2007	2008	2009	2010	2011	2007	2008	2009	2010	2011
General economic background										
Real GDP [1]	4.7	0.7	-4.8	9.0	7.5f	3.2	0.3	-4.3	2.0	1.6f
Labour productivity [2]	64.6	65.9	63.1	63.4	n.a.	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-0.8	1.0	2.8	-1.6	-0.5f
Real effective exchange rate [4]	94.3	95.4	91.0	103.6	70.0	121.4	123.2	118.3	109.0	113.1
Inflation rate [5]	8.8	10.4	6.3	8.6	6.5	2.3	3.7	1.0	2.1	3.1e
Unemployment rate [6]	8.8	9.7	12.5	10.7	10.2f	7.2	7.1	9.0	9.7	9.6
Employment										
Employment rate [7]	44.6	44.9	44.3	46.3	n.a.	65.3	65.8	64.5	64.1	n.a.
Employment rate - females [8]	22.8	23.5	24.2	26.2	n.a.	58.2	58.9	58.4	58.2	n.a.
Employment rate of older workers [9]	27.2	27.5	28.2	29.6	n.a.	44.6	45.6	46.0	46.3	n.a.
Long term unemployment [10]	2.3	2.3	2.8	2.8	n.a.	3.1	2.6	3.0	3.9	n.a.
Product market reforms										
Relative price levels [11]	70.1	68.2	63.5	71.3	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	21.1	22.7	19.8	20.4	n.a.	10.7	11.6	9.8	11.7	n.a.
Net FDI [13]	1.9	1.4	0.8	1.0	n.a.	3.9	2.2	2.1	1.0	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.5	0.6	0.6	0.6	n.a.
Business investment [16]	n.a.	n.a.	n.a.	n.a.	n.a.	18.7	18.4	16.2	15.9	n.a.
Knowledge based economy										
Tertiary graduates [17]	n.a.	7.6	8.0	n.a.	n.a.	13.8	14.5	14.3	n.a.	n.a.
Spending on human resources [18]	3.3	3.0	3.9	3.7	n.a.	5.0	5.1	n.a.	n.a.	n.a.
Educational attainment [19]	47.7	48.9	50.0	51.1	n.a.	78.1	78.5	78.6	79.0	n.a.
R&D expenditure [20]	0.7	0.7	0.9	n.a.	n.a.	1.9	1.9	2.0	2.0	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9	25.7	n.a.

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1999 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

13. Average value of inward and outward FDIs flows in % of GDP. 14. Market share of the largest generator (% of total net generation). 15. In % of GDP. 16. Gross fixed capital formation by the private sector in % of GDP. 17.Total tertiary graduates in science and technology per 1000 of population aged 20-29. 18. Public expenditure on education in % of GDP. 19. Percentage of the population aged 20 to 24 having completed at least upper secondary education. 20. GERD (Gross domestic expenditure on R&D) - in % of GDP. 21. Number of broadband access lines per 100 inhabitants.

f: forecast, e: estimated value, p: provisional value, b: break in series, s: Eurostat estimate, r: revised value,

Source: Commission services, national sources