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2010 Economic and Fiscal Programmes of potential candidate countries: EU Commission's assessments

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European Commission
Directorate-General for Economic and Financial Affairs

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2010 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia).

In 2001 a regular economic fiscal surveillance procedure was established for the candidate countries. It 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 Economic and Monetary Union. The Pre-Accession Economic Programmes (PEPs) are part of this procedure. The PEPs have developed, since their start in 2001, into increasingly important platforms for the authorities to develop and communicate appropriate economic, fiscal and structural policies over the medium term, consistent with their EU membership aspirations.

For this reason a similar exercise was started in 2007 with the potential candidate countries, with the submission and assessment of annual EFPs as important element.

The EFPs have two objectives: first, to outline a medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession; and, second, to offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with a derogation as regards the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and co-ordination of economic policies. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank in each country is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

All countries broadly complied with the deadline of 31 January 2010 for submitting the programmes. All programmes have been made public by the countries and can be found on the internet under following addresses:

Albania	http://www.minfin.gov.al/index.php?option=content&task=view&id=949&Itemid=239;
Bosnia and Herzegovina	http://www.dep.gov.ba/dep_publikacije/publikacije/?id=1268
Montenegro	http://www.mf.gov.me/ResourceManager/FileDownload.aspx?rid=52363&rType=2&file=1264779965.doc
Serbia	http://www.mfin.gov.rs/pages/article.php?id=9804

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Part I

Overview

1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Bosnia and Herzegovina, Montenegro and Serbia submitted by 31 January the *2010 Economic and Fiscal Programmes* (EFPs). The Albanian programme was received on 1 February. The preparation, assessment and discussion of these programmes serve to strengthen economic planning capacity in the countries and to prepare them for the next step, i.e. participation in the economic and fiscal surveillance procedure of candidate countries and, eventually in the more distant perspective of accession, in the economic policy co-ordination and budgetary surveillance mechanisms of the Economic and Monetary Union (EMU).

This year's programmes represent a step forward towards meeting this objective. They generally contain useful overviews of medium-term economic policy plans on a broad range of issues. In some cases they show the determination of the governments to advance further stabilisation, structural reforms and productivity gains in order to allow sufficiently high growth, catching up with the EU Member States and raising standards of living in the countries. The degree of ambition and precision in policy implementation across the programmes is not uniform.

The 2010 EFP exercise comes at a crucial juncture as it allows the stakeholders to assess the impact of the international economic and financial crisis which for the potential candidate countries reached a peak last year. More importantly, it provides an opportunity to examine the economic and fiscal strategies adopted thus far and re-assess their appropriateness in the emerging post-crisis scenario. It has become evident that, although the potential candidate countries have shown a degree of resilience, the overall growth dynamics will probably be lower than in recent years and that, contrary to what has been the case until now, countries will have to rely more on endogenous growth factors as competition for external funds might become harder.

The underlying macroeconomic assumptions of the 2010 programmes are broadly more realistic than last year since they take into consideration the impact of the crisis. Moreover, all programmes project a substantial improvement in the fiscal balance. For Serbia, fiscal consolidation is projected to be gradual and expenditure-based, reflecting a decline in current spending as a ratio to GDP. The deficit is expected to be financed through privatisation receipts and domestic borrowing, mainly by issuing treasury bills, as well as foreign borrowing from international financial institutions. Bosnia and Herzegovina projects current spending to follow a declining trend over the outlook period against relatively unchanged revenue which represents a risk to the planned budgetary outcomes if economic activity is less dynamic than assumed in the programme. Montenegro's fiscal consolidation is a result of public spending increasing at a much slower pace than revenue. Expressed as proportion of GDP, consumption, transfers and subsidies are anticipated to fall. While in all these countries, the fiscal consolidation is back-loaded for Albania the EFP projects a front-loaded budgetary adjustment. Although in the medium-term revenue is expected to increase reflecting an optimistic macroeconomic scenario, the fiscal consolidation is mainly the result of a decline in the expenditure-to-GDP ratio, to be achieved primarily through a reduction in capital outlays. The medium-term fiscal framework appears to be cautious in the case of Montenegro, broadly plausible for Serbia, slightly optimistic in the case of Bosnia Herzegovina and optimistic for Albania. All programmes fail to spell out in sufficient detail the medium-term measures underlying the planned improvement in the fiscal balance. The programmes' structural reform agendas, which become even more crucial for raising growth, are wide-ranging but lack concreteness and a time-table on future action while the link with the fiscal framework is not always obvious.

This exercise of submitting, assessing and discussing annual EFPs will continue to support the countries on their way towards European integration. The EU is in a position to provide an important anchor in this effort. A closer integration of this form of pre-accession economic and fiscal

surveillance with other instruments of pre-accession economic policy communication, i.e. the economic chapters of the Progress Reports and European Partnerships and the bilateral economic dialogues with the countries, could increase their effectiveness in this respect. Technical assistance in the area of economic policy planning and implementation has also proven a powerful tool in the case of candidate countries and might be more amply mobilised for the potential candidate countries.

1.2. BACKGROUND

In July 2006, the European Commission invited the potential candidate countries - Albania, Bosnia and Herzegovina, Montenegro and Serbia - to submit, for the first time, an Economic and Fiscal Programme to the European Commission.

The assessment of these programmes complements the policy messages given by the Commission in its annual enlargement package, as the economic chapters of the latter assess only past developments in the countries. In contrast, the assessments of the EFPs are forward-looking, take into account governments' medium-term plans, important for eventual full compliance with the Copenhagen economic criteria for accession.

The EFPs are gradually enabling the authorities to develop and communicate consistent platforms of 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 EMU. Consequently, the timing, structure and methodology of the EFPs, even though more limited in scope, mirrors the Pre-Accession Economic Programmes (PEPs) submitted since 2001 by candidate countries. The EFPs and their assessments are discussed in a multilateral policy framework with the Commission services, potential candidate countries and Member States. 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 Economic and Fiscal Programmes.

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

1.3. THE 2010 PROGRAMMES

All countries broadly complied with the deadline of 31 January 2010 for submitting the programmes and all programmes have been made public by the countries authorities.([1]) When analysing the programmes, the EU Commission assesses whether the provided information is in line with the required standards and whether the programme's overall scenario was plausible and consistent at the time of submission. The 2010 EFPs have been prepared taking into account the effects of the crisis in 2009. Consequently, in most cases, this year's programmes appear to be more realistic compared to the previous year.

([1]) Albania: http://www.minfin.gov.al/index.php?option=content&task=view&id=949&Itemid=239;
Bosnia and Herzegovina: http://www.dep.gov.ba/dep_publikacije/publikacije/?id=1268
Montenegro:http://www.mf.gov.me/ResourceManager/FileDownload.aspx?rid=52363&rType=2&file=1264779965.doc
Serbia: http://www.mfin.gov.rs/pages/article.php?id=9804

Table I.1.1:

2010 Economic and Fiscal Programmes: Key indicators

	2008	2009	2010	2011	2012
Growth (GDP, real, ann. % change)					
Albania	8.0	3.0	5.5	6.5	7.1
Bosnia and Herzegovina	5.3	-3.0	0.5	5.1	6.7
Montenegro	6.9	-5.3	0.5	3.5	4.0
Serbia	5.5	-3.0	1.5	3.0	5.0
Unemployment rate (%)					
Albania	12.7	12.7	12.1	10.8	9.7
Bosnia and Herzegovina	41.5	42.1	42.7	40.8	38.0
Montenegro	10.7	11.4	:	:	:
Serbia	14.7	17.4	n.a.	n.a.	n.a.
Current account balance (% of GDP)					
Albania	-14.9	-17.2	-13.1	-10.8	-10.0
Bosnia and Herzegovina	-13.2	-5.6	-9.2	-10.6	-9.9
Montenegro	-32.6	-16.5	-16.3	-15.4	-15.4
Serbia	-17.1	-5.7	-9.0	-10.5	-12.6
Inflation (CPI, annual % change)					
Albania	2.2	3.0	3.0	3.0	3.0
Bosnia and Herzegovina	7.4	-0.5	1.8	2.1	2.3
Montenegro	7.4	2.8	2.0	3.0	3.0
Serbia	12.4	8.1	5.1	5.2	4.2
Government balance (% of GDP) *					
Albania	-5.5	-6.8	-4.0	-3.2	-3.0
Bosnia and Herzegovina	-4.3	-4.4	-4.0	-2.3	-1.5
Montenegro	-0.3	-4.0	-4.3	-1.4	0.0
Serbia	-2.5	-4.2	-4.0	-3.5	-2.4
Government gross debt (% of GDP) *					
Albania	54.9	59.5	59.9	58.3	55.8
Bosnia and Herzegovina	n.a.	n.a.	n.a.	n.a.	n.a.
Montenegro	29.0	35.2	39.5	38.7	34.2
Serbia	25.6	31.3	34.0	34.8	34.3

* general government, national accounting standards

Source: EFP 2010

Overall,

- The four programmes present generally consistent and ambitious policy frameworks for economic stabilisation, fiscal policy and structural reform. In most cases, the methodology and presentation has improved in several instances compared to last year's submission. However, some

have deteriorated in quality and not all authorities appear fully committed to the exercise. In all four programmes, there is scope for further improvement. In general, all programmes show a commitment to strengthen administrative capacities and, in the longer run, to prepare for eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union.

- Most of the programmes are based on broadly realistic macroeconomic and fiscal frameworks. In taking into account the impact of the crisis in 2009, the potential candidate countries project annual real GDP growth between 0.5% and 7% over the programme period (table). With the impact of the economic crisis on the Western Balkan countries more apparent, the growth projections are, to varying degrees, more subdued compared to those foreseen in last year's EFPs. Rather optimistically, Albania foresees an average annual economic growth of about 6.5% over the programme horizon, whilst Bosnia and Herzegovina projects an acceleration of growth from 0.5% in 2010 to 6.7% in 2012, and Serbia from 1.5% to 5.0%. The Montenegrin EFP provides two alternative growth scenarios. Under the baseline scenario, which appears to be plausible, a modest economic growth of 0.5% projected for 2010 accelerates to 4% by 2012.

- The programmes foresee that in all countries, growth will be mainly driven by a global recovery and strengthening in domestic demand over 2010-2012. However, there are risks to the macroeconomic outlook presented in the EFPs mainly due to the uncertainty surrounding the recovery of the global economy as well as domestic risks, most notably the political commitment to implement the appropriate policies. These risks could put a damper on the anticipated growth trajectory which, while more subdued in most programmes compared to last year's vintages, may translate in a longer recovery in view of the adjustments needed.

- The monetary frameworks foresee no changes to the respective current setting, i.e. quasi-inflation targeting in Albania and Serbia, a currency board in Bosnia and Herzegovina and official euroisation in Montenegro.

- All EFPs project a substantial improvement of the fiscal balances over the programme horizon, even though to a lesser extent in the case of Montenegro, which will reach a balanced budget only in 2012. The Albanian budget balance is projected to remain in deficit, but to improve by a total of 3.8 percentage points of GDP during the period 2010-2012, while for Bosnia and Herzegovina the fiscal deficit is foreseen to be reduced by almost 3 percentage points of GDP. For Serbia, the fiscal deficit is projected to gradually decline by a total of 1.9 percentage points of GDP but also remain in deficit at the end of the programme horizon. For Montenegro, the baseline scenario projects an increase in the budget deficit in 2010 before declining in the outer years. Over the programme period, the public deficit is projected to decline by a sizeable 4 percentage points of GDP. As a result, the debt-to-GDP ratio for Montenegro is expected to fall from 35.2% of GDP in 2009 to 34¼% by 2011. For Albania, based on optimistic growth assumptions, the debt ratio is foreseen to decline by around 4 percentage points to 55¾% of GDP by 2012. For Serbia, public debt is anticipated to increase in 2010 and further in 2011 to 34¾% of GDP before declining slightly by the end of the programme period. Bosnia and Herzegovina did not provide data on consolidated public debt-to-GDP. Whereas in all countries the budgetary adjustment is expenditure-driven, the fiscal consolidation is back-loaded for Albania and front-loaded in the case of Bosnia and Herzegovina, Montenegro and Serbia.

- The structural reform agendas, as presented in the EFPs, cover a broad range of areas and reveal a varying degree of ambition. In Albania the reforms focus on the improvement of the business environment as the main objective, including facilitating business creation and making Albania more attractive for FDI. The programme of Bosnia and Herzegovina mentions some reforms in the privatisation agenda, the financial sector, labour market, public administration and the pension systems. For Montenegro, the emphasis is on reforms in the enterprise sector, the financial sector and the labour market. The programme of Serbia focuses on a wide range of structural reforms related to

the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. In most instances, however, the EFPs are very detailed when describing past developments but less clear when explaining intended reform measures. Furthermore, the EFPs would have benefitted from a more explicit discussion of the links of structural reforms to the macroeconomic and fiscal frameworks.

1.4. THE EFPS AND THE PRE-ACCESSION STRATEGY

The programmes lay out policy strategies which are to a large degree compatible with and conducive to the fulfilment of the economic priorities of the European Partnerships. Overall, the full and determined implementation of the announced reforms should strengthen the countries' economies, in particular in view of the fulfilment of the Copenhagen economic accession criteria, i.e. establishing a functioning market economy and raise competitiveness to a level which would allow the countries to meet competitive pressure within the European Union. In some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful, e.g. as regards ways to improve market exit mechanisms which remain highly inefficient throughout the region, or the prioritisation of public investment to raise the countries' competitiveness.

1.5. FOLLOW-UP

The programmes and their assessments by the Commission services were discussed within an experts meeting on 6 May in Brussels, with experts from the potential candidate countries, EU Member States, the European Central Bank and Commission services.

As this exercise was conceived to be on an annual basis, the countries will again be invited to submit next year a programme for 2011-2013.

Part II

Country analysis

1. ALBANIA

EXECUTIVE SUMMARY

Albania submitted the 2010 Economic and Fiscal Programme (EFP), covering the period 2010-2012, on 1 February. The key objectives of the programme are fiscal consolidation, while maintaining a high level of public investment and sustaining economic growth thereby ensuring faster convergence with EU levels. The programme is a welcome policy coordination instrument which is based on several medium-term government strategies. The 2010 EFP broadly complies with the requirements on format and content of the European Commission, although public finance data are not ESA95 compliant. The programme has some significant data gaps, which point to the need for further strengthening the statistical system, including statistical governance.

As a result of the global economic crisis, Albania's hitherto strong economic growth decelerated in 2009 but remained positive, the fiscal and external deficits widened and average inflation eased, albeit accelerating at year-end. The programme's macroeconomic outlook projects a rebound in real GDP growth to a strong 5.5% in 2010 and to 6.5% and 7.1% in 2011 and 2012, respectively. In the context of a still-fragile international and regional economic situation, the projected real GDP growth appears to be markedly favourable, especially for 2010. In particular, the underlying determinants for the very significant rebound of its key driver - private consumption - are not fully elaborated. Given downside risks, the EFP would have benefited from explicit alternative growth scenarios.

According to the programme, the government deficit reached 6.8% of GDP in 2009 which is significantly higher than the target of 4.2% of GDP in the original budget. The deviation was primarily due to revenue underperformance as a result of lower tax receipts compared to expectations, in particular from indirect taxation, mainly caused by the slowdown in growth and a reduction in the volume and price of imports. In addition, expenditure came in higher than planned on the back of higher capital spending. The programme gives a good overview of the medium-term fiscal scenario which foresees a frontloaded adjustment in the budget deficit, projected to reach 3% of GDP by 2012. Although the public finance scenario is adequate and supports the programme's policy goals as well as the attainment of the targeted policy-mix, the markedly favourable macroeconomic scenario underlying the budgetary developments makes the fiscal targets appear ambitious. This is especially the case in 2010 where the main bulk of the adjustment is to be achieved. The programme's treatment of fiscal risks is insufficient; although it provides for a contingency line of 0.4% of GDP to mitigate the risks of a shortfall in the projected revenues and/or to cover any unpredicted emergency expenditures and mentions risks related to interest rates and re-financing, quantitative information on the results of sensitivity analysis is not provided. The 2010 EFP does not provide a quantitative assessment of the long-term sustainability of public finances.

The programme's description of structural and institutional reform agenda is relatively adequate but could have benefitted from more clarity and details when outlining future plans. The link with the fiscal framework is not always obvious, while the programme does not provide a clear timetable for the implementation of the reforms and fails to quantify the budgetary impact of the measures. Otherwise, the implementation of reforms has kept pace. Further progress seems to be warranted in spelling out and implementing measures related to attracting FDI, further restructuring of the energy sector and improving the functioning of the labour market.

The main risks related to the programme include: (i) the markedly favourable macroeconomic scenario, especially for 2010, which makes tax projections and therefore budgetary outcomes appear optimistic; (ii) a less-than-projected decline in the current account deficit which in the event of

insufficient capital inflows, specifically FDI, could lead to an abrupt adjustment with a negative feedback loop on the real economy and an adverse impact on public finances; (iii) the possibility of spill-over effects of the international crisis, in terms of lower remittances and exports as a well as those flowing through the banking system, as a result of the weakening economic situation in the region; (iv) optimistic tax projections reflecting the markedly favourable macroeconomic scenario; (v) the significant roll-over needs for short-term domestic public debt; (vi) possible delays in the privatisation process; and (vii) the fact that the domestic political setting may make certain structural and institutional reforms more challenging to implement.

The programme's reform agenda is broadly consistent with the fiscal scenario and largely aligned with the reform requirements in view of the Albania's European Partnership priorities originating from the implementation of the Stabilisation and Association Agreement, as spelled out in the latest Progress Report and the European Partnership. Overall, the policy response to the global crisis has been appropriate, timely and targeted but, looking forward, it is necessary to return to a prudent fiscal policy thereby ensuring medium-term fiscal sustainability.

1.1. INTRODUCTION

Albania's fourth EFP, covering the period 2010-2012, was submitted on 1 February 2010 and was adopted by the Council of Ministers. The programme, which is an update of the previous year's EFP, is based on several policy documents such as the Programme of Government 2010-2013, the Medium-Term Budget Programme 2010-2012, the Sectoral Strategy for Public Finances and the National Strategy for Development and Integration (both 2007-2013).

A summary of recent macroeconomic developments is presented, a medium-term macroeconomic and fiscal framework is projected and an extensive description of structural reforms is provided. As regards structural reforms, the 2010 EFP sets out Albania's sustained efforts to continue aligning with the requirements in the European Partnership priorities originating from the implementation of the Stabilisation and Association Agreement, as spelled out in the latest Progress Report and the European Partnership.

1.2. KEY POLICY CHALLENGES

In the current still-fragile international and regional economic situation, Albania's key policy challenge is to ensure macroeconomic stability notably by adopting a more prudent fiscal policy that would lead to a decline in the public debt. This, together with continued implementation of structural and institutional reforms that make inward investment more forthcoming, should help Albania to reduce macroeconomic imbalances, notably the high unemployment rate and, especially against a background of muted risk appetite, the external account gap and dependence on foreign savings. At the same time, it is essential to continue to follow a prudent monetary policy by pursuing price stability and monitoring and supporting the financial system, particularly if the level of non-performing loans continues to rise.

With respect to the country's accession perspective, important challenges are reforming and strengthening the legal system, tackling the informal economy and addressing weaknesses in infrastructure and human capital.

1.3. ECONOMIC DEVELOPMENTS AND OUTLOOK

1.3.1. Recent macroeconomic developments

Following a period of strong growth in recent years, real GDP growth is estimated to have decelerated to 3.3% (3% according to the programme) in 2009, down from 7.9% in 2008 and 6% in 2007. ([2]) Economic activity during the first two quarters of 2009 continued to be strong, on the back of a relaxation of fiscal and monetary policies, but slowed down in the third quarter and contracted in the last three months of the year as the fiscal stimulus was gradually reduced making way for the lagged effects of the global economic crisis to set in. Inflation declined from a four-year high of 3.4% in 2008 to 2.2% in 2009, although higher import prices caused by both the increase of international commodity prices and a depreciation of the lek led to a build-up of inflationary pressures in the last quarter. After posting an improvement in 2008, labour market conditions showed the first signs of loosening in 2009. Starting from the second quarter, employment growth decelerated which halted the steady decline in the unemployment rate recorded since 2005. Nevertheless, wage growth accelerated in 2009, possibly reflecting the pay increases awarded to public service employees which, coupled with a weaker labour productivity, led to rising unit labour costs.

Table II.1.1:

Macroeconomic developments

	2008	2009	2010	2011	2012
Real GDP (% change)	8.0	3.0	5.5	6.5	7.1
Contributions:					
- Final domestic demand	11.8	3.8	6.2	6.2	7.9
- Change in inventories	0.0	0.6	-0.7	0.0	0.0
- External balance of goods and services	-3.8	-1.5	0.0	0.2	-0.8
Employment (% change)	1.8	0.9	2.0	2.7	2.5
Unemployment rate (%)	12.7	12.7	12.1	10.8	9.7
GDP deflator (% change)	3.5	2.3	3.1	3.1	3.0
CPI inflation (%)	3.4	2.2	3.0	3.0	3.0
Current account balance (% of GDP)	-14.9	-17.2	-13.1	-10.8	-10.0

Sources: Economic and Fiscal Programme 2010

In contrast to the adjustment observed in the region, the current account deficit remained almost unchanged in 2009 at 15.3% of GDP (17.2% according to the programme), from 15.5% of GDP in 2008 (14.9% according to the programme) An improvement in the merchandise trade balance and a higher services surplus was slightly outweighed by a deterioration in the balance of primary income and current transfers, the latter due to a fall in remittances. The programme covers well the main recent developments in the economy, while remaining data gaps point to the need to further strengthen the statistical system, including its statistical governance. In general, the information provided in the programme on the economic impact of the global economic crisis is limited (see box II.1.1).

([2]) This refers to real growth rates, calculated using a fixed base year method of deflation (with 2005=100). Fixed base year deflation is not the recommended method for calculating volume figures since it may give a distorted picture of growth developments in the case of substantial structural shifts in the economy.

Box II.1.1: **The impact of the global economic crisis and the policy response**

The impact of the international economic and financial crisis on the Albanian economy in 2009 has been limited and delayed, especially when compared to regional peers. This was due to several factors mainly, a relatively closed economy (for goods, the share of imports and exports to GDP stands at around 28%, while for services the ratio amounts to some 55%) and a low level of integration with the global financial markets, a still substantial, albeit declining, share of the agriculture sector which cushioned the effects of the external shock and supportive fiscal and monetary stances. The adverse effects of the crisis were mostly felt in the tradeable sector. Among the vulnerable sectors is the extracting industry and manufacturing dominated by inward SME processing operations. The construction sector has also contracted, especially in the second part of 2009 as worker remittances declined. In 2009, remittances fell by some 6.5% compared to 2008 and by some 18% compared to 2007. Over the years, remittances have emerged as a key source of foreign inflows and households' income in Albania.

The effect of the crisis on the financial sector has been limited due to Albania's low level of integration with the global market. The share of non-performing loans (NPLs) as a percentage of total loans reached 10.3% at end December 2009, up from 6.5% in the last quarter of 2008, which in turn, put some pressure on banks' profitability. The crisis dented the public's confidence in the banking sector. Deposit growth decelerated from the year-earlier levels between October 2008 and January 2009, contracted in almost all the months until September, but recovered thereafter. In December overall deposits increased by 6.9% year-on-year. They continued to rise in the first months of 2010 and stood at 12.2% in February 2010, a rate much below the pre-crisis levels. Though it remained positive, overall credit growth decelerated significantly during 2009 reaching 11.1% (y-o-y) in December. This trend continued in January and February 2010 with credit growth decelerating to 10.5% and 8.5% weighed down by slower corporate and consumer lending.

In response to tighter lending conditions and subdued inflationary pressures, the Bank of Albania (BoA) used the available monetary space to lower, in January and October 2009, its benchmark rate by a total 100 basis points to 5.25%, and employed open market operations (reverse repos and reverse repurchase agreements) to inject liquidity in the banking system. At the same time, the BoA continuously tightened regulation and strengthened surveillance to stem further the deterioration in banks' loan quality while encouraging more lending to be denominated in the local currency. In addition, the government raised guarantees on bank deposits to EUR 25,000 in March 2009. The new guarantee covers more than 80% of all bank deposits. During 2009, the Albanian lek witnessed downward pressure as weaker external trade and lower remittances resulted in falling foreign currency inflows, prompting the BoA to intervene heavily to stem the significant pressures on the currency. By December, the lek had depreciated by 11.4% and 3.3% (y-o-y) against the euro and the US dollar, respectively.

1.3.2. Medium-term macroeconomic scenario

The 2010 EFP foresees a gradual return to historical real GDP growth, forecast to reach an annual average of 6¼% over the programme period and driven mainly by domestic demand. In line with the higher pace of economic activity, the programme anticipates an improvement in labour market conditions as employment is set to grow by a yearly average of 2½% leading to a decline in the unemployment rate in 2010-2012. Inflation is anticipated to accelerate to 3% in 2010 and, reflecting the BoA's monetary policy target, remain unchanged in the outer years. The current account deficit is foreseen to fall gradually from an estimated peak of 17.2% of GDP in 2009 to 10% in 2012, primarily reflecting a significant increase in the surplus of the services account. Compared to last year's programme, the 2010 EFP expects lower growth in real GDP and employment over the period 2010-2012, a worse current account deficit, while inflation is assumed to be unchanged. The main justification of these revisions is the impact of the global crisis.

The macroeconomic scenario presented in the 2010 EFP appears to be markedly favourable for 2010 and somewhat favourable for 2011-2012. The macroeconomic forecasting capacity, which currently is based on financial programming techniques, needs to be improved bearing in mind that systematic over- and underestimation of GDP growth and its components may induce unwarranted fiscal policy responses. Moreover, the still-fragile global and regional economic scenario and the limited fiscal space suggest that there is a need to step-up structural and institutional reforms if the programme's objectives are to be achieved. The 2010 EFP mentions several macroeconomic scenarios diverging from the baseline, but quantification of the sensitivity analysis is not provided. Moreover, while the adverse external economic environment appears to be taken into account, the risks associated with the macroeconomic scenario are not discussed.

Real sector

The programme foresees a gradual return to historical real GDP growth over the outlook period. For 2010, GDP is set to grow by 5.5% driven by domestic demand and more specifically by private consumption. While the growth of fixed capital formation would decelerate markedly to 0.4%, due to a 30% decline in public investment in line with the government's planned fiscal consolidation, private consumption is foreseen to strongly rebound by 7.8%. The assumption of a return to pre-crisis growth rates does not provide a fully convincing explanation for such acceleration. The programme would benefit from presenting alternative macro scenarios given important downside risks, notably in 2010. Specifically, remittances, which have traditionally supported private expenditure, are expected to decline, while inflation is forecast to be higher. Moreover, in the current situation of tight lending conditions, banks' credit is not expected to sustain household consumption. In addition, support from labour income is foreseen to be limited. The full impact of the economic slowdown on the labour market will only materialise in 2010, while labour income, although supported by planned pay rises in the public service, is unlikely to increase significantly. The programme does not include projections for compensation per employee. While the external sector is assumed not to add to growth in 2010, a negative contribution cannot be ruled out as the projected private consumption could lead to a stronger-than-expected growth of imports and low external demand could limit the foreseen rise in exports.

For 2011-12, real GDP is forecast to accelerate to 6.5% and 7.1%, respectively, led by domestic demand. Growth in private consumption is foreseen to decelerate to an average 5¼% during 2011-12 while gross fixed capital formation is anticipated to increase substantially, led by private investment on the back of the assumed global recovery, favourable financing conditions and improved investor confidence. Government consumption expenditure is expected to increase again in 2011 and accelerate significantly at the end of the programme horizon. Despite the programme's assumed acceleration in Albania's export markets, and after reaching a peak in 2010, foreign sales of goods and services are set to decelerate in the forecast horizon, suggesting a loss of market share. Imports are also anticipated to decelerate in 2011 in line with a slower pace of exports, while higher domestic demand is projected to lift imports in 2012. As a result, the positive marginal contribution of net exports to GDP growth in 2011 will turn negative by the end of the programme period.

The EFP does not consider any possible deterioration of the labour market which usually follows the business cycle with a significant time lag. It foresees a rapid acceleration in employment growth of 2% in 2010 which is set to increase to a yearly average of 2½% in 2011-2012. Although the programme does not provide any clear explanation, the elevated job growth rates over the period 2010-2012 which are above average historical values, appear to result from the assumed expansion in industry (9%), construction (6%) and services (7%). As a consequence, and after having stabilised in 2009, unemployment is projected to resume a downward path, from 12.7% in 2009 to 9.7% by 2012. The job-intensive growth predicted by the 2010 EFP implies that over the period 2010-2012 productivity gains, while remaining the main driver of economic growth, will be subdued compared to the historical average. Against a potential growth rate of typically around 6%, the economic outlook

for 2011-12 is on the optimistic side. In view of the current global outlook and the uncertainties surrounding the economies in the region, growth in 2010 might be significantly lower than expected, before returning to trend in the outer years. Even such a reduced rate depends on: (i) the successful implementation of the envisaged policy mix; and (ii) external risks to the outlook not fully materialising.

Inflation

Although decelerating for the whole year, inflation started to pick up in October 2009 mostly as a result of a base effect, rising international commodity prices, increases in administrative prices and the depreciation of the lek which increased import prices. Year-on-year inflation reached 3.5% in December and continued to accelerate reaching 4.4% in February 2010. The rise in the first two months of 2010 was driven mainly by higher electricity tariffs as well as an increase in prices of unprocessed food. The latter possibly reflects lower supply caused by the floods in North Albania which has badly hit agricultural land. In the event that the supply bottlenecks in agriculture persist, it is likely that inflation will continue to inch up given that the weight of food in the CPI is significant (37.2%). Similarly, any further depreciation of the lek as well as the likely rise in commodity and oil prices as the world economy gradually recovers, will add to inflationary pressures, not to mention the strong projected recovery of domestic demand. For the outer years, the 2010 EFP assumes an unchanged inflation rate in line with the mid-range of the BoA's inflation target. Although such an assumption may be motivated by the need to take a normative view, in the event that external assumptions suggest otherwise, it may raise doubts on the inflation outlook and compromise the macroeconomic scenario.

Monetary and exchange rate policy

The BoA's main policy objective remains the achievement and maintenance of price stability defined as an inflation rate of 3% with a band of +/- 1 percentage point. The publicly announced target has anchored inflation expectations and is considered by the authorities to be appropriate for a catching up transition economy. The growth of money supply is used as an intermediate target, managed via the setting of the repo rate and by open market operations. However, Albania's monetary policy faces an important constraint in the form of currency substitution. Around half of the assets and liabilities of the banking system are denominated in foreign currencies (mainly euro and U.S. dollar) - a factor that hampers the efficiency of monetary policy transmission.

Albania continues to operate under a free float exchange rate regime with the value of the currency determined in the foreign exchange market. Foreign exchange interventions are limited to softening sharp movements in the exchange rate while maintaining adequate reserve cover. Efforts to stabilise the exchange rate over the medium- or long-run are ruled out by the BoA. In addition, the Bank aims to further develop the domestic financial system and the level of financial intermediation which, although increasing in the years prior to the global crisis, still remains at a moderate level. The country's monetary policy stance continues to be appropriate and represents an important element of stability in the overall macro-fiscal medium-term framework.

External sector

According to the 2010 EFP, the current account deficit will fall gradually from an estimated peak of 17.2% of GDP in 2009 to 10% of GDP in 2012. In 2010, the current external deficit is expected to decline to 13.1% of GDP, on the back of a rebound in services exports (+15.2%) due to stronger earnings from tourism and a return to a positive balance of primary income. For 2011-2012, the programme anticipates a further narrowing of the current account deficit to 10.8% of GDP and 10%, respectively. According to the programme, the improvement in the outer years is mostly driven by a threefold increase in the services balance (from 0.9% of GDP in 2010 to 2.8% in 2012).

Improvements are also foreseen in net factor incomes and current transfers, although the latter at a slower pace reflecting an expected gradual reduction of remittances. The programme does not discuss the underlying factors driving the sizeable changes on the external account, which is clearly inadequate. Moreover, the 2010 EFP fails to consider the risks surrounding key categories such as remittances which may experience a sharper drop as labour market conditions in host countries deteriorate rapidly.

Despite the adverse international economic situation, foreign direct investment (FDI) in 2009 came in somewhat higher than expected at 9% of GDP, mainly reflecting privatisation proceeds. The 2010 EFP assumes FDI to stay at 6.3% of GDP in 2010 and to average around 5¼% of GDP in 2011-2012. This outlook for foreign direct investment appears to be optimistic against a background of weak global risk appetite. A further risk lies in the assumption that, contrary to the past years, FDI will be predominantly of the green-field type, making it contingent upon a successful implementation of structural and institutional reforms. Overall, the discussion of projected financial and capital account developments is not sufficiently detailed in the programme.

Main risks to the macro-economic scenario

The macroeconomic scenario presented in the 2010 EFP appears to be markedly favourable for 2010 and somewhat favourable for 2011-2012. In view of the lagged impact of the global crisis on Albania, the full consequences may linger well into the first half of 2010, affecting unemployment and therefore private consumption. Household consumption may be less dynamic than foreseen in the programme in the face of tight lending conditions, spurred by a possible further rise in NPLs, as well as lower remittances especially in the wake of protracted economic weakness in major trading partners like Greece. The latter may also weigh on exports. In view of these downside risks and with private consumption amounting to 80% of GDP while contributing for some 6% of the programme's projected GDP growth, economic activity may turn out lower in 2010. The change in external conditions that underpinned the past elevated GDP growth rates in the pre-crisis period suggest that the programme's growth forecast for the outer years may also be somewhat favourable. As foreign financial inflows become less forthcoming, increasing domestic savings and fostering sources of endogenous growth may become necessary.

The risks to the external sector include a lower-than-projected improvement in the services balance which would result in the current account deficit narrowing by less. Moreover, in a context of a still-high current account deficit the inability to attract sufficient capital inflows, specifically FDI, will lead to an abrupt adjustment with a negative feedback loop on the real economy and an adverse impact on public finances represents another risk.

1.4. PUBLIC FINANCE

The 2010-2012 EFP fiscal strategy envisages a declining budget deficit which is projected to reach 3% of GDP by 2012. The fiscal consolidation, which is front-loaded, is planned to be achieved mainly by a decline in the expenditure-to-GDP ratio, primarily in the form of lower capital spending. Accordingly, the debt-to-GDP ratio is projected to follow a downward path, falling from 59.5% of GDP in 2009 to 55¾% by 2012.

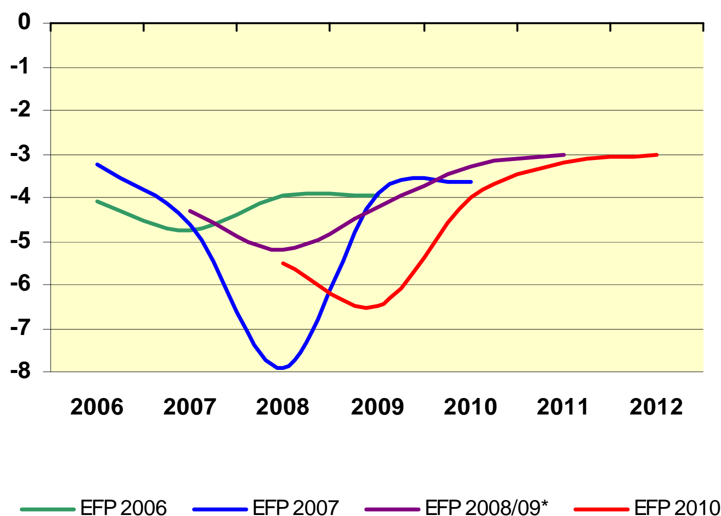
Although the public finance scenario is adequate and supports the programme's policy goals as well as the attainment of the targeted policy-mix, the markedly favourable macroeconomic scenario underlying the budgetary developments makes the fiscal targets appear ambitious, in particular in 2010 where the major part of the adjustment is to be achieved. The programme's treatment of fiscal risks is insufficient; although it provides for a contingency line of 0.4% of GDP to mitigate the risks of a shortfall in the projected revenues and/or to cover any unpredicted emergency expenditures and

mentions risks related to interest rates and re-financing, the quantitative information on the results of sensitivity analysis is not provided. The 2010 EFP does not provide an assessment of the long-term sustainability of public finances and does not mention to what extent fiscal data are compatible with the ESA95 methodology.

1.4.1. Budget implementation in 2009

The government deficit for 2009 was initially targeted at 4.2% of GDP, including a contingency line of approximately 2% of GDP, earmarked to address fiscal downside risks. This contingency was however already partly used to fund the increase in expenditure due to higher public wages as of May 2009. In view of the worse-than-expected results, the Parliament approved a supplementary budget in September which revised upwards the 2009 fiscal deficit to 6.4% of GDP and again in December to 6.9% of GDP. The worse-than-planned deficit reflects both revenue underperformance and expenditure slippages. Revenue in 2009 amounted to 26.4% of GDP or 2 percentage points less than planned as direct and to a lesser extent indirect taxes and social contributions suffered in the wake of weaker economic performance. ([3]) Total expenditure reached 33.2% of GDP, 0.6 percentage points higher than anticipated. The spending overruns were primarily driven by capital outlays on the construction of the key *Durres-Kukes* motorway.

Graph II.1.1: **Budgetary developments (general government balance, % of GDP)**



* As from 2009 the Economic and Fiscal Program is presented end-January, instead of December (2008)

1.4.2. Medium-term budgetary strategy

On 26 November, the Parliament adopted the 2010 budget, envisaging a fiscal deficit of 3.9% of GDP. The budget assumes real GDP growth of 6.5%, while average annual inflation is projected to be 3%. At 4% of GDP, the programme's deficit target for 2010 is slightly higher than that set in the 2010 budget. The difference between the deficit projections in the 2010 budget and the programme are due

([3]) It should be noted that the supplementary budget includes receipts from privatisation under total revenue which were not included in the original 2009 budget. Receipts from privatisation are considered as financing item rather than a revenue stream.

to the latter's downward revision of GDP growth for 2010 and more updated information on the budgetary implementation in 2009.

The EFP projects total revenue to rise marginally by 0.2 percentage points to 26.6% of GDP in 2010, while total expenditure is expected to reach 30.6% of GDP, a decline of around 2.6 percentage points compared to the previous year. The revenue side includes the full year effects of the 2009 increase in excise tax rates on some alcoholic beverages, coffee and tobacco products and the broadening of the tax base effective as of 1 January 2010 resulting from the reduction from EUR 8 million to EUR 5 million of the turnover threshold beyond which businesses are subject to VAT. Reductions in customs duties in line with various trade agreements will result in lower indirect tax revenue. Finally, the programme underscores the continued efficiency in the tax administration as a reason for the projected rise in revenue.

The measures on the expenditure side mainly reflect lower capital spending which is projected to decline by almost 3 percentage points to 6.3% of GDP in 2010. Most of this decline will affect spending on infrastructure - a key priority sector – which, however, will still constitute around two-fifths of public investment. ([4]) The 2010 EFP foresees differentiated public sector wage increases of 4-10%, effective as of mid-year, with a budgetary impact of some 0.4% of GDP. Pension increases in the range of 7-15%, effective as of mid-year, will see a rise in expenditure of 0.4% of GDP.

Viewed against tax elasticities, revenue projections for 2010 appear to be on the optimistic side as the programme implicitly assumes that elasticities return to the pre-crisis values. This is particularly the case for indirect tax revenue, which accounts for three-fourths of tax receipts and which is expected to increase by some 10% in 2010. However, in terms of average tax rates, i.e. the ratio of tax revenue to the respective tax base, which is considered to be more appropriate in times of changing tax structures and adverse economic conditions, revenue projections appear to be more plausible. Nevertheless, the downside risks stemming from the macroeconomic outlook, specifically the strong growth in private consumption and employment growth, suggest that the programme's targeted deficit of 4% of GDP in 2010 may be optimistic. In the event that revenue undershoots, achieving the deficit target may necessitate additional expenditure restraint, and shifts in the composition of spending (such as scaling back capital spending) that do not support a growth-orientated public finance strategy.

Table II.1.2:

Composition of the budgetary adjustment (% of GDP)

	2008	2009	2010	2011	2012	Change: 2009-12
Revenue	26.8	26.4	26.6	26.8	26.9	0.6
- Taxes and social security contributions	22.2	21.7	22.1	22.4	22.6	0.8
- Other (residual)	4.6	4.6	4.5	4.4	4.4	-0.3
Expenditure	32.4	33.2	30.6	29.9	29.9	-3.3
- Primary expenditure	29.5	30.0	27.1	26.3	26.4	-3.6
of which:						
Gross fixed capital formation	9.5	9.2	6.3	5.9	6.1	-3.2
Consumption	10.4	10.2	9.7	9.2	9.1	-1.1
Transfers & subsidies	8.9	10.5	10.7	10.3	10.3	-0.2
Other (residual)	0.7	0.0	0.5	0.9	0.9	0.9
- Interest payments	2.9	3.2	3.5	3.6	3.5	0.3
Budget balance	-5.5	-6.8	-4.0	-3.2	-3.0	3.8
Primary balance	-2.7	-3.6	-0.5	0.5	0.6	4.2
Gross debt level	54.9	59.5	59.9	58.3	55.8	-3.6

Sources: Economic and Fiscal Programme 2010, Commisssion services' calculations

([4]) The other priority areas of government are education, health and the judiciary which in 2010 will see marginal increases in budgetary allocations.

The fiscal strategy for the period 2011-2012 comprises a still high level of public investment spending at an annual average of around 6% of GDP, an average increase of pensions at an annual rate of 11%, a (continued) differentiated increase of public wages and the reduction of the deficit to 3% of GDP by the end of the programme period. The fiscal consolidation, which is front-loaded, relies primarily on lower expenditure rather than higher revenue (table II.1.2). Specifically, gross fixed capital formation is projected to decline by 3.2 percentage points of GDP over the period 2010-2012. Expressed as a ratio to GDP, current spending is expected to remain unchanged. The latter does not appear plausible considering the planned increases in public sector wages and pensions which the programme fails to quantify, neither in terms of their impact on annual budgets over the programme horizon, nor in terms of their impact on the long-run sustainability of public finances. Revenue is foreseen to increase by 0.6 percentage points of GDP over the programme period mainly as a result of a higher intake of indirect taxes and social contributions. While such intake seems to be broadly realistic, as discussed earlier, the projection of tax revenue for 2010 could turn out to be difficult to achieve.

Summing up, in 2010 and to a lesser extent in 2011-12, the budgetary outcomes are subject to downside risks, which the EFP does not discuss. For 2010, this mostly relates to the markedly favourable macroeconomic scenario which makes tax projections appear optimistic. Moreover, the decline in expenditure envisaged in the programme relies mostly on a lower capital spending-to-GDP ratio which may overshoot due to cost overruns, notorious in projects. In addition, the EFP does not give an indication of the budgetary impact of the damages caused by the floods that hit North Albania in the beginning of the year. Although the existence of a contingency line of 0.4% of GDP could provide some buffer, it is evident that this would not be enough in the case of revenue underperformance and/or expenditure slippages. For 2011 and 2012, the risks to the projected fiscal consolidation, which relies mostly on a lower current expenditure-to-GDP ratio, relate to a possible underestimation of the budgetary impact of the planned increases in public sector wages and pensions as well as the lack of information on measures underpinning the consolidation in the outer years.

Budgetary implications of "major structural reforms"

The 2010 EFP does not give a clear picture of the budgetary impact of structural reforms since the requested matrix on policy commitments programme is not provided. Nevertheless, the programme mentions four major structural reforms: (i) autonomy of institutions of higher university education; (ii) centralisation of the provisioning and financing of health care; (iii) the setting up of a fund to compensate former land owners partly financed through government resources; and (iv) alignment of national and local budget policies. In terms of budgetary implication, the 2010 EFP mentions an above average increase for operational and maintenance expenses as a result of the education and healthcare reforms. Possible privatisations receipts, the main structural reforms with budgetary effects, were not included in the budget. While this is a financing component of the deficit (i.e. below the line), indicative amounts would have been welcome in view of the substantial deficits and considerable refinancing needs of public debt.

1.4.3. General government debt

In 2009, the debt-to-GDP ratio stood at 59.5%, representing a significant increase of 4½ percentage points from the previous year (table II.1.3). This jump in the debt ratio was mostly due to the deterioration in the primary deficit as well as a result of the depreciation of the lek against the euro, which the programme estimates to have increased the debt stock by 5%. According to the 2010 EFP, the debt will rise to slightly below 60% of GDP in 2010. The smaller increase in the debt ratio reflects a lower projected primary deficit and the anticipated strong nominal GDP growth which is set to neutralise the significant stock-flow adjustments of 1.2 percentage points, the latter possibly due to the effect of government deposits from higher contracted external debt and the effect of the assumed further depreciation of the lek on the debt stock. Thereafter, the programme foresees a decline in the debt ratio to 58¼% of GDP in 2011 and further to 55¾% by 2012. The programme's projected

Box II.1.2: Key characteristics of Albania's public debt

The downward trend in public debt from 62% of GDP in 2002 to 53% in 2007, was reversed in 2008 and is estimated to have reached 59.5% of GDP in 2009. The public debt consists of central government debt and while local governments can borrow as of April 2008, so far no use has been made of this possibility. Around 60% of total public debt is domestic, while guarantees - mostly external - account for some 6.5%. More than three-fifths of domestic debt is mainly short-term, i.e. with a maturity of 1 year and less, and consists of treasury bills. The 12-month T-bills account for the largest share (40%) in total domestic debt. Although the authorities have been issuing long-term bonds since 2002 in a bid to lengthen the maturity of the public debt, the demand for these instruments has been limited in the prevailing weak economic situation giving rise to refinancing risk.

Until 2008, Albania benefitted from concessional terms on its public external debt largely contracted from bilateral and multilateral institutions and having fixed interest rates. The average maturity of external debt currently stands at some 11.4 years, while two-thirds of Albania's external debt is denominated in euro. In 2009, the authorities accessed international commercial sources through a syndicated loan amounting to EUR 200 million to part-finance the deficit. In 2010, the authorities are expected to conclude a EUR 300-350 million debut Eurobond issue with international financial institutions with an expected maturity of 3-5 years. Most of this is earmarked to re-pay the syndicated loan and the remainder to partly finance the 2010 budget deficit.

Looking forward, the programme foresees a sharp increase in the share of external debt in the total debt stock in 2010, suggesting that the difficulties in long term domestic borrowing are expected to persist in the current year. Thereafter, the share of foreign debt is expected to stabilise in 2011 and decline in 2012.

reduction in the debt ratio is driven mainly by an improvement in the primary balance (expected to turn positive in 2011) and stronger nominal GDP growth, while stock-flow adjustments are assumed to be insignificant.

The programme’s projected reduction in the debt ratio is back-loaded and mainly concentrated in 2012. Apart from the rollover risk stemming from the short-term bias of the debt structure, the programme mentions fluctuations in the interest rate and the exchange rate as major risks to the evolution of debt, although no sensitivity analysis is provided. Given the substantial size of the public debt, the budgetary room for manoeuvre can become rapidly constrained in the event of an increase in interest rates. This could become even more the case as Albania seeks access to non-concessionary financing with variable interest rates. In this light, the relative importance of interest rate risk to the budgetary outcomes should be quantified. The programme puts less emphasis on the impact of exchange rate risk with respect to the evolution of debt, although it mentions that an appreciation of 11% of the euro/lek exchange rate would lead to an increase of 5% of the debt stock. The programme does not discuss the risks to the debt stemming from a worse-than-expected economic performance. In line with the arguments discussed earlier, a slower GDP growth than projected in the programme would result in lower tax revenue, a worse government deficit and thereby a higher public debt.

Table II.1.3:

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

	2008	2009	2010	2011	2012
Gross debt ratio [1]	**54.9**	**59.5**	**59.9**	**58.3**	**55.8**
Change in the ratio	1.7	4.6	0.5	-1.6	-2.5
Contributions [2]:					
1. Primary balance	**2.7**	**3.6**	**0.5**	**-0.5**	**-0.6**
2. "Snow-ball" effect	**-2.7**	**0.4**	**-1.2**	**-1.7**	**-1.9**
Of which:					
Interest expenditure	2.9	3.2	3.5	3.6	3.5
Growth effect	-5.8	-3.4	-4.3	-5.3	-5.5
Inflation effect	0.2	0.6	-0.4	0.0	0.0
3. Stock-flow	**1.7**	**0.6**	**1.2**	**0.5**	**0.0**

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 accounting, accumulation of financial assets and valuation and other residual effects.

Source: Economic and Fiscal Programme; Commission services' calculations

1.4.4. Quality of public finance and institutional features

The government has maintained its strategy to keep the structure of public spending oriented towards growth, with a high though declining level of public infrastructure spending, decreasing subsidies, and by stepping up efforts to improve the efficiency and effectiveness of the education and the healthcare sectors. However, the programme does not explicitly mention measures relating to the quality of public finance. On the revenue side, the main thrust has been the decentralisation and financial autonomy of local government. The administration of the small business tax has been successfully decentralised. Although commendable in principle, there is a perception that weak local government administration capacity is limiting the process of decentralisation from attaining the desired goals by hampering business investment.

The 2010 budget has introduced a fund providing for schemes whereby regional/local authorities will be granted funds on a competitive basis to support regional development. The strategy of broad-based taxes with low rates is conducive to low levels of economic distortion, and the system of reference wages may help to reduce tax evasion and the informal economy but should be complemented by a fully-fledged tax compliance system. Overall, the major challenge to the programme lies in addressing the downside risks on the revenue side thereby minimising uncertainty and the encroachment, forced by events, on growth-enhancing capital spending.

After a new organic budget law was adopted in 2008, with implementation starting in 2009, all budget organisations at the local and central level as well as special fund units are presently included in the medium-term budget planning process. Under this new set-up, the focus has shifted from input budgeting to output and performance budgeting. For the time being, Albania does not have an explicit fiscal rule in place.

1.5. STRUCTURAL REFORMS

The programme presents a thorough review of product market and financial sector reforms but could have benefitted from more clarity and details when outlining future plans especially in the area of attracting FDI, further restructuring of the energy sector and improving the functioning of the labour market. In addition, the link with the fiscal framework is not always obvious, while the programme does not provide a clear timetable for the implementation of the reforms and fails to quantify the budgetary impact of the measures. The main risks to the implementation of the reforms relate to the issue of enforcing property rights which is considered to be the main hurdle in the attraction of investment, possible delays in the privatisation process and the fact that the domestic political setting may make certain reforms more challenging to implement.

1.5.1. Product and capital markets

Product and capital market reform continued to gather pace with important results. The establishment of the National Licence Centre, a one-stop shop, has appreciably facilitated business registration and shortened licence and permit turnaround, thereby reducing the administrative burden. The 2010 EFP mentions a number of initiatives aimed at further improving the business climate. However, more emphasis could have been laid on those measures in support of attracting FDI. Most importantly, the EFP fails to provide concrete plans to address the long-standing issue of property rights, which is considered to be the main hurdle in the attraction of investment. Moreover, the programme does not treat the issue of late payments or tax reimbursement by government to the private sector which is exacerbating cash-flow difficulties, especially during the current weak economic situation. Integration with other sections of the programme, notably the macro and fiscal scenarios the plausibility of which partly relies on the attraction of green-field FDI, is inadequate. Such FDI inflows will become even more pertinent especially as the large-scale privatisation draws to an end.

The restructuring of the energy sector continued to advance, in an effort to solve the chronic supply and financial shortcomings that have inflicted this strategic sector for a long number of years. Following the unbundling of the electricity company, the distribution arm, OSSH, was privatised for EUR102 million to the Czech power group CEZ in 2009. Details on the next steps in the restructuring of the energy sector are limited to deciding on the possibility of further privatisation. The government seems to have recently changed its privatisation policy of the energy sector. Contrary to the indications provided in the EFP, the government will not privatise energy transmission, while a decision whether to spin-off the production arm will be taken in the medium-term. In addition, an evaluation of all the remaining government assets that have a potential for privatisation will be carried out during this year. In 2009, the government sold its remaining shares in AMC a mobile telecommunications company. For 2010, the programme mentions plans for the privatisation of Albpetrol and Albtelekom. Regrettably, the 2010 EFP does not spell out the government's reform plans in the areas of telecommunications and competition policy, including state aid.

The banking sector, now fully private-owned, has undergone a rapid transformation along the years and is the primary source of financial intermediation. Despite the difficult global environment, the banking sector remains well capitalised and stable even though profits have declined and non-performing loans increased sharply during 2009 and may continue to rise in 2010. Still, the banking sector in Albania has more scope to grow given that the loan-to-deposit ratio is well below 100%. In response to the international financial turmoil, the authorities have bolstered supervision by adopting a number of regulations aimed at, *inter alia*, improving liquidity risk, limiting credit risk, increased provisioning in the case of loans denominated in foreign currency to mitigate exchange rate risk, and making the granting of loans and mortgages more transparent. In addition, additional steps were taken to further liberalise the movement of capital in line with EU legislation during 2009. Monetary limits for carrying out transactions have been lifted while procedures and documentation have been simplified. In 2010, further regulatory reform will continue to implement parts of Basel II, sharpen

legal provisions for bank receivership and liquidation and review capital requirements for banks. The programme does not clearly specify the next steps to be taken towards the full liberalisation of the capital account. Nevertheless, the programme's reform agenda in the area of capital markets appears fully adequate and ambitious, and it supports well the policy-mix targeted by the authorities.

1.5.2. Labour market

Albania's labour market strategy is based on both active and passive policies. The National Strategy of Employment and Vocational Training, adopted in 2007, continues to be the cornerstone of the labour market strategy and is largely in line with European Partnership priorities. A number of ongoing and planned programmes aim to improve the functioning of the labour market, including initiatives for on-the-job training, financial incentives for job creation and vocational training, the latter also with a special focus on women, ethnic minorities and young persons. Female unemployment reached some 50% of the jobless, while the long-term unemployed accounted for a high 65% of total unemployed in 2009. The budgetary impact of these initiatives appears to be very low, which also applies to passive employment measures. The programme reports that the reduction in employers' social contributions carried out in 2009 has resulted in positive outcomes in terms of reducing informal employment, although no concrete evidence is reported. In 2009, unemployment benefits were increased by 6%, but the actual number of recipients remains very small, partly due to strict eligibility criteria.

Looking forward, the programme underlines a series of initiatives in a bid to encourage more people into the labour market. Apart from the continuation of the ongoing programmes and new initiatives, the 2010 EFP pays more attention on improving the co-operation among stakeholders (i.e. universities and the social partners) and strengthening the information and monitoring of the job market, aspects which have been so far a weakness in the institutional aspect of the labour market. The programme also envisages a yearly increase in unemployment allowances of 10-20% until they reach 50% of the minimum wage. Further development in social welfare programmes is foreseen over the programme period with a major policy priority in the medium-term being a gradual move to a multi-pillar pension system. At the same time, the policy on pensions aims to equalise by 2012 the pensions of persons living in rural areas with those in urban areas. As of 2008, urban and rural pensions were raised in yearly steps at differentiated rates and are expected to be increased further by 6 and 15%, respectively, each year over the period 2010-2012. While the programme provides some information on measures to tackle the informal economy, no information is given on the approximation of EU practices in the areas of health, insurance and safety at the workplace. It is weak on the strategy to tackle the mismatch between demand and supply in the labour market and skills upgrading. Despite ongoing initiatives, the plans spelled out in the programme to reform the education system and therefore enhance human capital, remain insufficient. The EFP does not address the issue of reducing disparities in unemployment across regions. The lack of a detailed quantification of policy measures in the area of social assistance, pensions and wages in the 2010 EFP, hinders an assessment of the budgetary implications. Moreover, the programme does not provide data on total wages which is regrettable and should be corrected in the future.

1.5.3. Other reform areas

Public administration continues to be an important area of reform. Initiatives in this regard include functional reviews and streamlining, strengthened internal financial control as well as employee training to tackle skills gaps in the public service. The re-organisation of the public service involves also compensation adjustments with the apparent goal to increase wage spreads with a view to better attract specific skills. While this may enhance productivity, the potential role of differentiated wage increases acting as a signal to wage claims in the private sector should not be overlooked. In this respect, it is appropriate that wage policies take consideration of the BoA's inflation target so as to safeguard the overall policy-mix.

1.6. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

The programme's macroeconomic framework is coherent, consistent and sufficiently comprehensive. It does not provide alternative scenarios while almost all the relevant data are covered. In describing the past economic developments, the document is too lengthy and would have benefitted from more clarity.

The fiscal framework is sufficiently comprehensive and consistent, but lacks coherence with the medium-term economic outlook. Specifically, revenue projections are not sufficiently in line with economic developments affecting the various tax bases. The fiscal framework is integrated into the overall economic policy strategy and addresses European Partnership priorities such as implementing a stability-oriented fiscal policy which aims at fiscal consolidation, without however explicitly referring to them. The programme explains well policy measures that were implemented in the past including their effect on revenue. Key revenue and expenditure measures for 2010 are well explained but a quantification of their budgetary impact is not always provided. For the outer years, the explanation of measures is less comprehensive while their budgetary cost is not spelled out. The programme does not provide reasons why nor does it state when fiscal data will become compatible with ESA95 methodology.

The 2010 EFP presents a very extensive but largely descriptive outline of the structural reform agenda. It remains vague on the overall strategy and more importantly on the link between the reforms and the fiscal objectives. The document does not contain a matrix of policy commitments and does not feature any policy priorities, while it lacks a quantification of the budgetary impact of the measures. Overall, the strategy is largely supportive for the fulfilment of the economic Copenhagen criteria, while it addresses the economic criteria as described in the European Partnership priorities.

2. BOSNIA AND HERZEGOVINA

EXECUTIVE SUMMARY

In January 2010, Bosnia and Herzegovina (BiH) submitted to the European Commission its 2010 Economic and Fiscal Programme (2010 EFP) covering the period 2010-2012. The programme aims at supporting the objectives of the Stand-By Arrangement (SBA) that was agreed with the IMF in mid-2009, in particular the consolidation of public finances through a reduction of public consumption, which is a welcome objective. The programme broadly complies with the content and form required, but the data provided is often scarce. In general, the means to achieve the objectives of the programme are not adequately explained or quantified.

The repercussions of the international economic crisis drove BiH into a recession in 2009. The 2010 EFP estimates real GDP growth to have been at -3% in 2009, far below the 5.3% recorded in 2008. The sharp drop in the current account deficit to 5.6% of GDP in 2009 was mainly caused by decreasing imports and import prices. Inflation turned slightly negative (-0.5%). The expected budget deficit of 4.4% of GDP in 2009 may seem high and furthermore on the optimistic side. However, the fiscal outcome would have been worse without the budget support provided by the IMF. For 2010, a moderate positive growth of 0.5% is expected, before a return to pre-crisis growth rates is assumed for 2011 (5.1%) and 2012 (6.7). This macro-fiscal framework deviates to a certain extent from the one agreed with the IMF. The recovery will be led by private consumption, investments and exports. The growth scenario for 2010 seems broadly realistic, while the ground for the strong recovery in the following years may not be that solid. Sound fiscal policies remain crucial in order to support the much needed adjustment process.

The fiscal performance in 2009 was severely affected by the repercussions of the economic crisis on BiH. Revenues decreased as a result of declining imports and domestic demand. As the authorities had not used previous years of strong economic growth to create sufficient fiscal space, they had to resort to the IMF in view of the economic crisis. Despite the international support, deficits were still much higher than planned and budgets had to be rebalanced several times during the course of the year. The public finance scenario gives an overview of the country's fiscal targets for 2010-2012 which are guided by the agreements with the IMF. However, only short-term measures are described. The programme lacks an explanation of the medium-term policy mix necessary to turn onto a path of fiscal consolidation, and an assessment of risks.

The structural reform agenda as presented in the 2010 EFP is not sufficiently ambitious. Progress in privatisation and structural reforms has been slow. More emphasis on the necessary improvement of the business environment and attracting foreign direct investment would have been beneficial. The programme hardly provides any quantitative estimates of the effects of reform measures.

Main risks to the programme stem from the international economic environment and the domestic political sphere where resistance to some necessary reform measures is high. However, the programme lacks a comprehensive analysis of these risks.

The programme's reform agenda is broadly consistent with the fiscal scenario and partly aligned with the reform requirements in view of the country's European Partnership priorities, findings of the Progress Report and the implementation of the Stabilisation and Association Agreement. The overall policy response of the 2010 EFP to the international economic and financial crisis, however, is not sufficient.

2.1. INTRODUCTION

The 2010 EFP of Bosnia and Herzegovina covers the period 2010-2012 and was submitted to the Commission on 15 January 2010, well within the requested deadline. The programme was adopted by the Council of Ministers of BiH, being regarded as a key document on the path towards European integration. It is, however, not well integrated into the budgetary procedures and its use as a policy making tool could be improved. In particular, the programme would benefit from a closer link to the country's accession process, such as the assessments in the European Commission's Progress Reports and priorities defined in the European Partnership documents. The programme is an update of the 2009 EFP.

2.2. KEY POLICY CHALLENGES

Relatively high economic growth rates in the years until 2008 somewhat masked the fact that this growth was built on unsustainable grounds as it was fed by rapid credit growth, external financing and expansionary fiscal policies that fuelled domestic consumption and created macroeconomic imbalances. While the currency board arrangement has worked well as a monetary stability anchor, it needs to be complemented by a credible domestic fiscal anchor, as already defined in the European Partnership priorities. The short-term fiscal measures implemented in the context of the IMF programme can only be a first step towards sustainable fiscal policies in the medium- to long run.

Besides the need for fiscal consolidation, the country faces a number of additional challenges in its process towards EU accession that are described in the European Partnership priorities and the Progress Reports. In particular, Bosnia and Herzegovina needs to step up its efforts in a number of structural reform areas, such as the privatisation process in the Federation, the pension system, high social contribution rates particularly in the Federation, the functioning of the labour market, the improvement of the business environment, law enforcement, the production of reliable economic statistics or an effective supervision of financial markets.

2.3. ECONOMIC DEVELOPMENTS AND OUTLOOK

2.3.1. Recent macroeconomic developments

In the context of the international economic crisis BiH fell into a recession in 2009 with growth estimated in the EFP at -3.0%([5]) after +5.3% in 2008. The economic downturn was mainly caused by a drop in private domestic consumption, investments and a contraction of external demand, starting in the fourth quarter of 2008. Private consumption which accounted for 79% of GDP in 2009 fell by 2.9%, after it had been rising strongly in previous years (5.6% in 2008). Gross fixed capital formation, accounting for 19% of GDP in 2009, dropped by 26% after it had registered a positive growth of almost 10% in the previous year. This contraction of private domestic demand could not be offset by the development of government consumption (accounting for 20% of GDP in 2009), which grew by 1.2% in 2009, and the reduction of the trade deficit by almost 30% (net exports accounting for -20% of GDP in 2009). As a consequence of these trade developments, the current account improved remarkably disposing a deficit of 5.6% of GDP in 2009([6]) after 13.2% of GDP in 2008, according to the EFP. As regards different industrial sectors, manufacturing (-4.6% growth of production in 2009([7]) and mining (-2.8%) were the most affected, while the energy sector remained relatively robust

([5]) -3.2% according to more recent estimates.
([6]) 7.5% according to more recent estimates.
([7]) This figure is somewhat blurred by the effects of the reopening of an oil refinery in December 2008 which drove the annual growth rate in the subsection of coke and refined products to 499% (!) in 2009.

(+0.1%). Within the processing industry, the highest annual production drops were registered in metal (-17.2%), machinery (-22.3%) and wood (-16%) products which are all highly dependent on external demand. Overall, industrial production in BiH decreased by 3.3% in 2009([8]). Developments in early 2010 show first signs of recovery: The year-on-year drop of industrial production came down to 0.4% in the first two months; exports soared by 18% annually, while imports dropped by a mere 5.8%. An effect of the crisis on the labour market could be felt throughout 2009 but particularly in the first half of the year. Overall, the traditionally very high rate of registered unemployment increased from 40.6% in December 2009 to 42.7% a year later. Workers were released mainly in the private sector while the number of employees in the public sector increased by 2.9% year-on-year in December 2009. Sectors most affected by rising unemployment were the processing industry and construction.

The description of macroeconomic developments in 2009 in the EFP is broadly realistic, even though latest estimates point to a slightly lower GDP growth rate. Where final data is not yet available, the EFP relies on assumptions based on available data for parts of the year and on projections of the external environment and the domestic economy by the European Commission and the IMF.

Table II.2.1:

Macroeconomic developments

	2008	**2009**	**2010**	**2011**	**2012**
Real GDP (% change)	5.3	-3.0	0.5	5.1	6.7
Contributions:					
- Final domestic demand	7.9	-8.4	2.5	7.3	6.5
- Change in inventories	0.2	0.7	0.1	0.1	0.1
- External balance of goods and services	-2.6	5.4	-2.0	-2.3	0.2
Employment (% change)	4.7	-3.5	-1.3	0.1	3.0
Unemployment rate (%)	41.5	42.1	42.7	40.8	38.0
GDP deflator (% change)	7.3	2.7	0.9	2.9	2.4
CPI inflation (%)	7.4	-0.5	1.8	2.1	2.3
Current account balance (% of GDP)	-13.2	-5.6	-9.2	-10.6	-9.9

Sources: Economic and Fiscal Programme 2010

([8]) All figures on industrial production in 2009 are based on a release by the Statistical Agency of BiH.

Box II.2.1: **The global financial crisis: First impact and policy response**

The global economic and financial crisis revealed its impact on Bosnia and Herzegovina in the last quarter 2008. Trade dynamics slowed drastically and a "mini bank-run" in October threatened financial stability. The slowdown of economic activity continued in 2009 as a result of lower domestic and external demand, reduced financing and falling foreign direct investments. The trade deficit narrowed by almost 30% in 2009 leading to a substantial improvement of the current account. Public finances increasingly came under stress in early 2009 as the result of falling revenues and high spending commitments. The stress on financial markets eased due to an appropriate reaction of the Central Bank and an improvement in market sentiment. Private deposits have been channelled back into the banking system and the fall of Central Bank reserves was reversed due to the IMF's Stand-By Arrangement disbursement and SDR allocation in summer 2009. Commercial banks are well-capitalised and liquid but both reduced demand and a more risk-averse supply have pushed the previously very high annual credit growth rates into negative territory in September, reaching -3.9% in December. Inflation has declined sharply from almost 10% in mid-2008 to negative rates in the last quarter 2009, mainly due to drops in food and energy prices.

Because of the legacy of poor fiscal policies which had been expansionary in the pre-crisis period, feeding a very large public sector and a generous system of – mainly untargeted – social benefits, the authorities, especially in the Federation, did not have enough reserves when revenues started to dry out in 2009 as a result of falling consumption and imports. Therefore, they had to turn to the IMF and the international community for external support. The short-term fiscal measures agreed with the IMF amounted to 0.7% of GDP on the revenue side and 2.5% of GDP on the expenditure side, relieving the pressure on the budgets. However, these measures were unevenly implemented and revenues developed even worse than foreseen so that the envisaged deficit target (-4.7% of GDP, already revised downwards from the initial 4.4%) could not be reached. In any case, it remains to be seen whether the short-term measures will be complemented by a sustainable and credible improvement of the quality of public finances in the long run. The legislation agreed with the World Bank and adopted in February 2010 to reform the system of social benefits to privileged groups in the Federation was necessary in order to get social benefit expenditures to a sustainable level. However, challenges remain for consolidating public finances and reducing the generally large public sector in the country.

2.3.2. Medium-term macroeconomic scenario

In contrast to the previous year's programme, the 2010 EFP presents a forward-looking medium-term macroeconomic scenario. It assumes a full recovery of the world economy by 2011, leading to high growth rates in Bosnia and Herzegovina of 5.1% in 2011 and 6.7% in 2012, after only a moderate growth of 0.5% in 2010. This scenario deviates to a certain extent from the one agreed with the IMF under the SBA([9]). The recovery as of 2011 will be driven by consumption, investments and exports. Industrial production will be spurred by external demand, especially in the processing industry. Unemployment will be reduced. Trade will pick up, spurring a widening trade deficit and, consequently, a widening current account deficit which is set to reach around 10%% of GDP between 2010 and 2012([10]). Current transfers will increase and so will FDI on the back of some major privatisation deals to be completed in 2011 or 2012. Foreign reserves are set to increase substantially by more than 80% between 2009 and 2012. Inflation rates are expected to range slightly above 2% in the medium-term, mainly influenced by international price developments.

([9]) GDP growth projections are more optimistic which partly leads to a more pessimistic projection of current account deficits.
([10]) There is a discrepancy in the trade figures for 2011 and 2012 (developments of imports and exports, current account) between the text in chapter 2.1.1 and table 1f in the annex which somehow aggravates the analysis. The text suggests higher current account deficits than the table. In this analysis, the figures from the table are used as a reference.

The medium-term macroeconomic scenario presented in the 2010 EFP is broadly plausible and the underlying assumptions are overall realistic. This is a welcome improvement compared to the previous programme. However, the expected outcome for 2011 and 2012 seems to be on the optimistic side as it is based on a return of the world economy to full steam in 2011, not taking into account the risks to this scenario. The EFP lacks a convincing link between the mix of fiscal and structural policies as elaborated in the programme and the presented macroeconomic scenario. Some structural reforms are discussed, unfortunately without a comprehensive analysis of their fiscal impacts. An analysis of risks to the macroeconomic scenario is not elaborated.

Real sector

The 2010 EFP is based on a scenario of recession in 2009, followed by an only mild recovery in 2010 and a strong one in the following years. The economic downturn in 2009 was mainly caused by a contraction in both internal and external demand. In 2010, the pick-up in imports will be higher than that in exports, thus trade will contribute negatively to growth. Domestic demand is expected to be the main driver of the mild recovery in 2010, as both private and government consumption are expected to slightly increase([11]). Fiscal policy will remain expansionary with an expected budget deficit of 4% of GDP. Investments will also slightly pick up, even though difficulties in their financing will remain. It is assumed that the recovery of export markets will affect positively the processing industry in BiH, in particular the metal, mechanical, wood processing and chemical industry. Infrastructure projects and investments in new power generating facilities will spur the production of construction materials. Overall, the EFP estimates a 3.8% rise in industrial production for 2010. The strong recovery in 2011 and 2012 will be driven by expected positive developments in the world economy and especially in the EU as the country's largest trading partner from which particularly the export-oriented processing and metal industries will benefit. Domestic demand will also pick up on the back of relaxed access to financing. The fiscal deficit is set to slowly decrease over the programme horizon. Government consumption expenditure will substantially increase in 2011 and 2012, back to pre-crisis levels. Growth will also be supported by investments, especially in the energy, construction and financial sector. Though expected to fall from 2011 onwards after a peak in 2010, the unemployment rate will remain high. Correspondingly, employment is expected to grow from 2011 on, supported mainly by a growth of employment in the public sector. The productivity of labour (as measured by real GDP per person employed according to the Labour Force Survey) is expected to grow between 4½ and 10% annually.

The favourable growth scenario depicted for 2011 and 2012 seems to be on the optimistic side and in the upper range of what can be estimated a potential growth rate for BiH.

Inflation

The inflation in Bosnia and Herzegovina is strongly influenced by international price developments, especially of oil and food. 2009 displayed a negative inflation rate of -0.5%([12]), reflecting base effects and the downward trend of international food and energy prices. Afterwards, the inflation rate is expected to gradually increase from 1.8% in 2010 to 2.3% in 2012, thereby it is projected to remain slightly above euro area levels. Given the monetary policy regime (see below) and the evident influence of international prices on domestic inflation, inflation is seen as an exogenous macroeconomic variable. Nevertheless, possible domestic drivers of inflation, such as wage increases and the fiscal relaxation pursued in recent years could also have been examined.

([11]) The envisaged increase of government consumption is in contrast with the SBA and declared plans to reform public sector pay and wage bill management.
([12]) -0.4% according to the latest figure published by the Statistical Agency.

Monetary and exchange rate policy

Bosnia and Herzegovina continues to run a currency board fixed to the euro which has worked well as a stabilising monetary anchor. There is a wide consensus in favour of keeping this arrangement and in the course of the economic crisis it has proven again its stability. Therefore, no alternatives are discussed in the EFP. The Central Bank of Bosnia and Herzegovina increased the liquidity of the banking system in several consecutive steps between end-2008 and mid-2009 by lowering the minimum reserve requirement rate, with the aim of strengthening and restoring confidence in national financial markets and of stimulating credit activities. As the nominal exchange rate is fixed against the euro, the evolution of the real exchange rate is determined by the inflation differential vis-à-vis the euro area. By projecting higher inflation, the programme implicitly assumes an appreciation of the real exchange rate against the euro.

External sector

In contrast to the previous submissions of EFPs, the 2010 EFP does contain forward-looking estimates of the external balances, which is a welcome improvement([13]).

The current account deficit falls exceptionally to 5.6% of GDP in 2009, caused by the drastic reduction of the trade deficit. In the following years, it is expected to reach around 10% of GDP. Export growth is expected to pick up in 2010 and to increase from 7.4% in that year to 13.1% in 2012. In contrast, import growth is projected to slow down from 12.8% in 2010 to 10.3% in 2012. Nevertheless, the trade deficit is still growing over that period as imports are much higher than exports. In absolute terms, the trade deficit will exceed the 2008 level in 2012. The current account deficit is expected to be financed to a high and growing share by increasing foreign direct investments based to a large extent on some major privatisation deals to be implemented over the coming years in the Federation. Privatisations worth around EUR 850 million are planned for the programme period in the Federation([14]). Given the almost complete standstill in the privatisation process in the Federation in previous years, caused not only by an unfavourable economic environment but also to an important extent by political decisions, this seems to be a very ambitious goal. The sustainability of the projected development of the current account, therefore, has to be questioned. Official foreign indebtedness also plays an important role in financing the current account deficit, as it is set to rise by almost 50% from 2009 until 2012 in the context of the international balance-of-payments and budget support packages. The domestic savings rate in BiH is projected to remain at or below the pre-crisis level while domestic private investments will not recover to their pre-crisis level at the end of the programme horizon in 2012 (both in terms of GDP). The whole scenario of the external sector as presented in the 2010 EFP suggests a return to the vulnerable growth pattern of the pre-crisis period. In fact, the projected current account deficits for 2010-2012 seem to be on the high side, as domestic demand may remain more subdued than expected in the EFP.

Main risks to the macro-economic scenario

Like in previous years, risks to the macroeconomic scenario are not comprehensively discussed in the 2010 EFP. Risks to the programme can mainly be defined on the downside, stemming from the international economic environment and the domestic political sphere. The programme foresees a full recovery of the world and EU economy by 2011. While there are indeed indicators supporting that scenario, high uncertainties remain([15]). As the programme founds the expectation of a fast recovery of

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([13]) However, slightly different scenarios and figures are presented in the text and the table 1f in the annex. For the following analysis, the figures from table 1f are used.

([14]) The privatisation process in the Republika Srpska is much more advanced and basically finished, so no significant deals can be expected in this entity any more.

([15]) In its latest interim forecast from February 2010 the European Commission pointed out that the EU was benefitting from improved sentiment indicators, but industrial production and retail sales figures amongst others had been less promising,

Box II.2.2: **A revision of Bosnia and Herzegovina's growth model?**

The EFP projections basically postulate a return to the pre-crisis growth model that was based on externally financed high domestic consumption and characterised by a low level of domestic savings and persistently high current account deficits. This implies a growth pattern highly dependent on foreign savings and external financial inflows. Such a development strategy is vulnerable to a turnaround in capital flows, possibly spilling over into a domestic financial and real sector crisis. Therefore, the country's growth strategy should put more emphasis on attracting capital flows that can enhance the competitiveness and the productive capacity of BiH, while moderating those which would fuel domestic and external imbalances. First of all, a more responsive business environment, better prioritisation of public expenditures and the removal of distortions in taxation would gradually support an increase in the private sector's savings ratio while at the same time enhancing the attraction of FDI. Fiscal policy can also play a key role – increasing the structural balance of the public sector being the most direct way for enhancing domestic savings. Secondly, policy makers need to give priority to implementing appropriate regulatory and prudential frameworks, in particular in the monetary and financial area so as to discourage excessive leveraging and cap the growth of financial assets to levels compatible with reasonable risk-taking. Of particular importance are the improvement of the business environment and the acceleration of labour market reforms, given the insufficient contribution of labour input to growth. A vigorous policy action should put growth on a more sustainable and dynamic path, allowing Bosnia and Herzegovina to gradually decrease the still large gap in living-standards compared to the EU average.

the Bosnian economy mainly on the favourable assumptions about the international economic environment, there are high risks of negative repercussions on exports, the availability of financing, internal demand, and revenue projections from the world and EU economy in case the recovery is less pronounced than expected. In addition, there are domestic political risks that should not be underestimated. Resistance among the population and political decision-makers to some of the necessary structural reforms is high, as for example regarding the reform of the system of social benefits in the Federation of Bosnia and Herzegovina which could only be approved in Parliament at the end of February 2010 under high pressure from the international community. The availability of funds under the IMF programme, the World Bank Development Policy Loan and also the Commission's macro-financial assistance, however, is linked to this and other reforms, meaning that the country would not only risk losing the benefits of the reforms themselves, but also the access to the international financial support. Besides, general elections are scheduled for October 2010 which increases the possibility of discretionary and expansionary fiscal measures.

2.4. PUBLIC FINANCE

The fiscal strategy of the Bosnian authorities is closely linked to the requirements of the IMF programme. No medium-term objectives that would go beyond them are presented in the EFP. However, it is agreed that the high share of public expenditure in GDP needs to be reduced, in line with the European Partnership priorities and the findings of the Progress Report. Nevertheless, the fiscal scenario only presents a slow trend towards that goal, so that at the end of the programme horizon in 2012 the expenditure to GDP ratio still stands at 40% (down from 43% in 2009). It remains unclear, though, where this reduction is supposed to come from. While the reduction of current expenditure agreed under the IMF SBA and effective as of 2009 and 2010 will have some impact on fiscal balances over the programme horizon, the EFP is very scarce on any medium-term measures on

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and investments remained weak. Adding a probable weak labour market outlook dampening demand, and many of the growth sources being of temporary nature, the robustness of the EU recovery is yet to be tested.

the expenditure side, not to talk about quantitative estimates of related fiscal costs. It is striking that while the reduction of the ratio of government expenditures to GDP is one of the main objectives of the EFP and a key priority of the European Partnership, the related chapter in the EFP contains only two short paragraphs that do not contain any substantial information. The revenue to GDP ratio remains practically unchanged during that period, reaching 38.5% in 2012. Some estimates on revenue development are provided. Revenues from VAT are expected to rise as a result of growing domestic demand, while revenues from customs are set to decrease despite higher imports, as trade will be further liberalised in the context of the Stabilisation and Association Agreement. The corresponding budget deficit is set to be reduced from 4.4% in 2009 to 1.5% in 2012([16]). For the first time, the EFP does not project a surplus at the end of the respective programme horizon. A comprehensive analysis of total public debt is not provided in the EFP([17]). The implicit rate of public debt to GDP for 2009 (September figures as provided in the EFP) is around 28½% of GDP([18]). For the rest of the programme period, only estimates for foreign public debt are provided, which rises from approximately 19% of GDP in 2009 (September figures) to 25% of GDP in 2012([19]).

The track record of fiscal policy in Bosnia and Herzegovina in recent years has not been very promising. The fiscal space created by the introduction of VAT in 2006 was not used for the consolidation of the budgets but for unproductive purposes such as continuous high increases of public sector wages at all levels of government, generous and untargeted social welfare spending and a further enlargement of the already large public sector. As a consequence, the consolidated budget balance turned from surpluses until 2006 to high deficits from 2008 onwards. The EFP describes the adjustment measures agreed with the IMF and the World Bank in 2009 whose main components are a reduction of wages and allowances in the public sector and a reform of the rights-based system of social benefits to some privileged groups in the Federation towards a means-tested system. These adjustments are overdue and will – in conjunction with the international budget support packages – significantly contribute to a stabilisation of public finances. However, the presentation of fiscal risks could have been more straightforward and better quantified and the EFP remains relatively silent about any further envisaged medium-term measures which are necessary for a really sustainable consolidation of public finances not depending on external funds.

2.4.1. Budget implementation in 2009

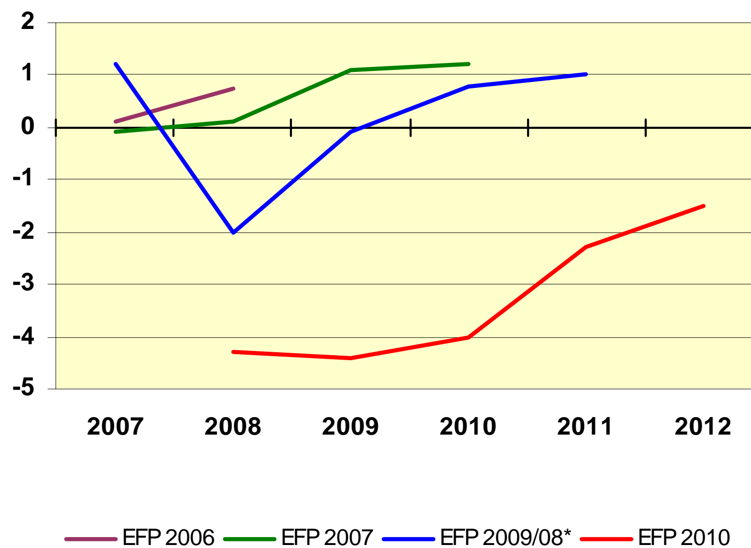
The 2010 EFP does not describe in much detail budgetary developments in 2009. According to the figures presented in the annex, the general government deficit amounted to 4.4% of GDP. However, more recent estimates point to a higher figure, even though budget reports have not been published by the time of drafting this assessment. Revenues are set to have decreased by 1.7 percentage points of GDP and expenditure by 1.6, as compared to 2008. About half of the revenues originated from taxes, of which 80% are indirect taxes which showed a severe negative trend in 2009. During the first three quarters of the year they decreased by 12% annually, mainly caused by a fall in custom revenues due to the strong decline of imports and import prices and the reduction of tariffs following the entry into force of the Stabilisation and Association Agreement with the EU in mid-2008. For the whole year, a fall of 10.3% in indirect taxes was expected, according to the EFP. Social contributions, the next biggest source of income, are set to remain relatively stable in terms of GDP over the programme horizon.

The estimated budgetary outcome for 2009 deviates substantially from planned levels. According to adopted budgets, an almost balanced consolidated budget was initially planned. While to a large extent this is due to the widely unexpected effects of the economic crisis especially on revenues, it

([16]) These figures are below the ones estimated by the IMF, partly due to the fact that they do not include foreign-financed capital expenditures and their corresponding financing via foreign investment grants and external loan drawings.
([17]) The corresponding table 4 in annex 2 is empty.
([18]) Own calculations on the basis of figures provided in the EFP.
([19]) Own calculations on the basis of figures provided in the EFP.

also reveals some shortcomings in the budget planning capacity. While the State budget is expected to have recorded a small surplus in 2009, the fiscal situation in both Entities remained difficult. In order to comply with IMF requirements and to bring the expected deficits closer to the levels agreed in the programme, both the Federation and the RS revised their budgets several times during the course of 2009 (three times in the Federation and twice in the RS). In the Federation, revenues fell short of projections and current expenditures exceeded their budgeted values. This was partly offset by reductions in capital spending. In the RS, social contributions and direct taxes developed better than planned and increased annually by 5% in 2009, offsetting shortfalls in indirect tax revenues. However, expenditures on wages and salaries are expected to have exceeded budget plans.

Graph II.2.1: **Budgetary developments (general government balance, % of GDP)**



* As from 2009 the Economic and Fiscal Program is presented end-January, instead of December (2008)

2.4.2. Medium-term budgetary strategy

Like in the previous EFP, fiscal scenarios are presented for each of the different levels of government which increases the transparency and comprehensiveness of the budgetary overview. However, the use of the countrywide GDP as deflator instead of the individual ones blurs somewhat real fiscal developments at the entity level. The programme envisages a consolidated budget deficit of 4% of GDP in 2010. Revenues are expected to reach 38.9% of GDP, while expenditures would reach 42.9% of GDP. The State and the entities adopted their 2010 budgets shortly before the end of 2009. Adopted budgets slightly deviate from the fiscal scenario presented in the EFP. At State level, the volume of the adopted 2010 budget is 1% lower than the 2009 budget, disposing a budget deficit of 0.6% of countrywide GDP which is planned to be financed by savings from the 2008 and 2009 budgets, by drawing on the succession funds of former Yugoslavia and by credits from the international community. The 2010 budget of the Federation is 16% lower as compared to the third rebalancing of the 2009 budget, disposing a deficit of around EUR 225 million, or 1.6% of countrywide GDP. According to the plan, the current expenditures of the FBiH administration and current grants will increase, by 8% and 7% respectively, while a reduction of 33% is envisaged in capital expenditure. Total revenues in 2010 are expected to decrease by 1.4% compared to 2009. The deficit in 2010 is

planned to be covered by credits from the IMF, the World Bank and the European Commission. The volume of the 2010 budget of the RS is unchanged as compared to the revised 2009 budget, disposing a deficit of around EUR 250 million, or 1.8% of countrywide GDP. Current expenditures are envisaged to increase by 3% compared to 2009. Total expected revenues are projected to be 1% lower than in 2009, as a 3% decline in indirect taxes is expected to be compensated by an increase in property tax revenue resulting from new legislation, as well as increased administrative fees. According to the plan, the deficit should be financed from long-term borrowing of EUR 112 million, from repayment of loans extended by the government in previous years, and the financial support by international institutions.

Overall, budgetary measures in 2010 described in the EFP include an increase of excise on cigarettes; a carry-over of a surplus created by savings in the 2009 budget related to the IMF programme and a filling of only one third of vacant positions in the public sector at State level; the reform of social benefits, the link of the growth of all allowances in the public sector to inflation instead of average salary and the reform of pensions within the accelerated retirement plan in the Federation; and reduced wages to employees of the self-government units, in extra budgetary funds and in public enterprises and other savings in extra-budgetary funds in the RS. These measures are mostly not quantified, so their budgetary impact is hard to judge. Nevertheless, they are necessary, though probably not sufficient in order to consolidate public finances and to reach the envisaged budgetary outcome, given the uncertainty about the evolution of revenues and the economic activity in general. Given the country's performance in recent years, it furthermore remains to be seen to what extent they will not be undermined by expansionary fiscal measures that may be decided in the context of the upcoming elections.

Table II.2.2:

Composition of the budgetary adjustment (% of GDP)

	2008	2009	2010	2011	2012	Change: 2009-12
Revenues	40.3	38.6	38.9	38.5	38.5	-0.1
- Taxes and social security contributions	33.3	31.6	32.6	32.2	32.3	0.7
- Other (residual)	7.0	7.0	6.3	6.3	6.2	-0.8
Expenditure	44.6	43.0	42.9	40.8	40.0	-3.0
- Primary expenditure	44.1	42.5	42.3	40.2	39.4	-3.1
of which:						
Gross fixed capital formation	5.7	5.1	5.4	5.3	5.0	-0.1
Consumption	18.7	19.6	19.7	18.7	18.3	-1.3
Transfers & subsidies	14.4	15.1	14.6	14.1	13.7	-1.4
Other (residual)	5.3	2.7	2.6	2.1	2.4	-0.3
- Interest payments	0.5	0.5	0.6	0.6	0.6	0.1
Budget balance	-4.3	-4.4	-4.0	-2.3	-1.5	2.9
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-3.8	-3.9	-3.4	-1.7	-0.9	3.0
Gross debt level	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: Economic and Fiscal Programme 2010, ECFIN calculations

The programme is vague about the path of fiscal policies in 2011 and 2012; budgetary measures beyond 2010 are not explained. According to the EFP, the State budget is supposed to be balanced in 2011 and 2012. In the Federation the budget deficit will be reduced to 1.5% of countrywide GDP in 2011 and 1.1% in 2012, in the RS to 0.8% and 0.4%. This results in a reduction of the consolidated budget deficit to 2.3% of GDP in 2011 and 1.5% of GDP in 2012, with the bulk of the adjustment taking place in 2011. The adjustment is almost exclusively expenditure-led as the revenue to GDP ratio remains practically unchanged throughout the programme period. The expenditure to GDP ratio is projected to fall from 43% of GDP in 2009 to 40% of GDP in 2012. This path is much less

ambitious – but probably also more realistic – than in the previous programme which foresaw a ratio of 33.6% in 2011.

The programme plans a fiscal consolidation of around 3% of GDP for the period 2009-2012, but it fails to analyse fiscal risks and to reveal how to achieve this objective, apart from short-term measures related to the IMF programme and their expected medium-term effects. Risks stem especially from lower than expected revenues from indirect taxes and customs in case the economic recovery turns out to be less pronounced than foreseen for 2011 and 2012. In addition, there are risks that the cuts foreseen in current spending may not be implemented to the planned extent and/or revised when fiscal pressures diminish. Furthermore, risks are related to lower privatisation proceeds in the Federation and liabilities related to the deposit insurance and social spending.

Budgetary implications of "major structural reforms"

The programme does not provide a clear picture of the impact of structural reforms on the country's fiscal position. The matrix of policy commitments (annex 3) was not provided.

2.4.3. General government debt

The 2010 EFP provides projections for the evolution of public foreign debt, whereas for public domestic debt only the stock as of 30 September 2009 is given. The stock of total public debt as of 30 September 2009 reaches approximately 28½ of GDP, relatively stable as compared to 2008 levels. The external debt of BiH is projected in the EFP to increase by 48% in nominal terms between 2009 and 2012, climbing from 19% of GDP to an estimated 25% of GDP. While the loans stemming from international support packages make up approximately half of this increase, the remaining part will have to be financed from other sources. Currently, foreign debt is mostly denominated in euro (39.2%), SDR (32.8%) and USD (15.5%). Given the country's currency board arrangement, this currency structure of external debt is relatively favourable, even though some risks stem from the EUR/USD exchange rate development, if the appreciation trend of the USD of recent months continues. A large part of the debt is contracted on concessional terms which sets the average interest rate at only 2.98%. 57% of external debt is agreed with fixed interest rates which leaves the rest open to the risk of a rising interest rate level. The maturity structure is quite favourable, as there is no official short-term foreign debt.

The debtor for external debt is the sovereign country of Bosnia and Herzegovina. However, internally the debt is allocated to the entities and the State level. The servicing of the debt, therefore, also follows this distribution, while the State Ministry of Finance and Treasury has the overall responsibility. According to the EFP, approximately 63½ % of the debt servicing in 2010 is done by the Federation, 35½ % by the RS, and 1% by the State institutions. The programme describes a proposal for a draft law to amend the Law on Indebtedness, Debt and Guarantees, aiming at expanding the purpose and range of state guarantees. So far, they are covered by a provision that they cannot exceed 30% of the value of public revenues determined at the time of the respective decision, and they can only be issued for loans that finance capital investments. The EFP does not explain to what extent the law is intended to be changed. However, the intention of the proposed amendment counteracts a prudent fiscal policy as it increases the risks to the budget stemming from these implicit or explicit guarantees and also goes against the positive evaluation of the debt laws from the 2009 EFP assessment. Domestic debt is totally managed by the entities. Its level is estimated at around 11% of GDP. 51% of this debt falls on the Federation and 46% on the RS (the remaining part on the Brčko District). The Federation was quite active in issuing bonds in 2009 at the amount of EUR 275 million and plans to issue bonds at the amount of EUR 25 million in 2010 and EUR 30 million in 2011 to settle claims for old foreign currency savings and war claims. The RS issued bonds at the amount of EUR 190 million in 2009. From 2010-2012 the FBiH plans to settle EUR 170 million of liabilities, and the RS EUR 200 million.

Information on below-the-line operations and stock-flow adjustments is not provided (table 4 in annex 2 is empty) and therefore cannot be assessed.

2.4.4. Quality of public finances and institutional features

The programme contains no policy strategy to improve the quality of public finances and no concrete revenue and expenditure measures in this respect. It describes the intention to improve the quality of fiscal statistics, though, which would certainly increase the transparency and accountability of budgetary processes. In a first phase the emphasis will be laid on including lower levels of government in the reporting procedures. While 2009 may be considered as an exceptional year taking into account the effects of the economic crisis, the fact that the budgets had to be rebalanced several times on all levels of government could also point towards a weak capacity of budgetary planning. In addition, the budgetary process is quite fragmented, especially in the Federation.

The EFP does not elaborate on other dimensions of the quality of public finances such as the size of the public sector, the sustainability of public finances or the composition and efficiency of revenue and expenditure systems. The goal of an improved composition of public spending, where more resources are allocated for capital investments and less for government consumption and social transfers seems to have gone out of sight. The share of the formation of gross fixed capital to GDP remains practically unchanged over the programme horizon, while its share in overall expenditures only moderately increases from 11.8% in 2009 to 12.5% in 2012, according to the EFP. The bulk of expenditures goes to government consumption, social transfers and subsidies, practically unchanged (80.7% in 2009; 80% in 2012), with a bias towards large and poorly targeted redistributive expenditures. Looking at 2010 budgets, an even further shift towards current expenditure can be observed, especially in the Federation. The significant differences between the levels and dynamics of officially registered and survey-based labour data point to the existence of a fairly large and growing informal labour market, caused inter alia by a high labour tax wedge. Furthermore, while the topic remains a major challenge in the country, the efficient use of resources in the public sector is not adequately addressed in the programme.

The fiscal architecture of Bosnia and Herzegovina derives from the structures created by the Dayton/Paris Peace Agreement. Direct taxation is under the competence of the two entities and the autonomous Brčko District, while the 14 cantons of the Federation also enjoy a large fiscal autonomy. Indirect taxation was harmonised across the country and a common value added tax (VAT) was introduced on 1 January 2006. Indirect tax revenues are pooled in a common single account. One consequence of the institutional set-up of the country is a multiplication of functions and the creation of inefficiencies in an overall big public sector.

The EFP describes the creation of a group for the coordination of fiscal statistical data for the monitoring of the SBA, under the responsibility of the Fiscal Council. Besides, the Indirect Taxation Authority has stepped up its efforts in the collection of indirect taxes as a reaction to a deterioration in the discipline of taxpayers that was observed in the economic crisis. No other institutional characteristics of public finances are reported. It remains to be seen to what extent the Fiscal Council can strengthen its role in fiscal coordination by, inter alia, establishing a comprehensive fiscal rule for all levels of government or common standards for a transparent budgeting process. To a certain extent, the coordinating role of the Council has been temporarily taken over by the arrangements with the IMF.

2.5. STRUCTURAL REFORMS

As regards structural reforms, the 2010 EFP focuses on the privatisation process and describes some reform efforts in the financial sector, labour market, public administration and the pension system.

The reform agenda, however, is vague on the overall strategy in certain areas as well as on their link to the programme's fiscal objectives, even though the success of the privatisation agenda has an enormous impact on public finances. In most instances, the reform plans are not backed by concrete measures or commitments for achieving the policy objectives and their effects are not quantitatively estimated([20]). Unlike in the previous programme, the reforms of health care, education and transport are spared out.

In general, the reform strategy is supportive to the fulfilment of the Copenhagen economic criteria and broadly follows the findings of the Progress Report. Nonetheless, it does not seem ambitious enough, in particular given the large backlog of reforms in the business environment, where the country clearly lags behind its peers. More concrete objectives and timetables for the acceleration of the privatisation process, , in particular in the Federation, and the restructuring and the liquidation of loss-making enterprises would have been welcome. In a similar vein, the reform commitments to reduce structural rigidities on the labour market appear to play only a secondary role on the reform agenda.

2.5.1. Product and capital markets

With regard to product markets, the programme focuses on enterprise privatisation and restructuring. Other measures to improve the business environment and foster private sector development are not provided. The EFP describes the failure of the Action Plan for privatisation in the Federation. It had intended to privatise 10% of the state capital until early 2010 in line with the European Partnership priorities but could not be adopted in Parliament. Therefore, the privatisation process in the Federation actually stood still in the last couple of years. The EFP now presents an ambitious plan for resuming privatisations in the Federation over the programme period with the major deals (telecommunication companies) to be implemented in 2011 or 2012. This plan aims at generating revenues of up to EUR 850 million. However, it does not convincingly explain how the political tensions can be overcome and it is hard to predict to what extent the expected prices can be achieved on the markets. Hence, uncertainties remain that could have serious repercussions on the Federation budget, on the possibility to attract FDI and, as a consequence, on the sustainability of external accounts. In the RS, the privatisation process is much more advanced. In 2009, there were no major privatisation deals. The programme fails to comprehensively outline the reform plans in the utilities and network industries, albeit the strong need for reforms in these sectors.

It would certainly be welcome if the privatisation process in the Federation was resumed. However, given the political sensitivities, the implementation of this agenda is highly uncertain. In addition, the capability of the markets to absorb the envisaged privatisation deals still needs to be tested and depends, inter alia, on the expected economic recovery in 2011 and 2012. On the other hand, there are also upside risks as mentioned in the EFP, as regards the prices that can be achieved in case of a favourable development of the respective companies' shares at the stock exchange markets.

Concerning financial markets, the EFP describes the establishment of a Permanent Commission for Financial Stability within the Fiscal Council at the end of 2009, which was one of the requirements of the IMF programme. This Commission shall improve crisis management and the coordination between the Ministries of Finance, the Central Bank and the Supervisory Agencies. Given the fragmentation of the supervisory structure in BiH this Commission is useful but it needs to be ensured that the flow of information also works on the technical level and that in case of a crisis, decisions can be quickly implemented. Furthermore, the upgrading of the supervisory framework (from Basel I to Basel II, improved international cooperation and analytical capacities) is mentioned. No information is provided on concrete legislative proposals or the timetable of the intended reforms. Besides the banking sector, no other segments of financial markets are dealt with.

([20]) Annex 3 containing the matrix of policy commitments was not provided.

2.5.2. Labour market

The programme focuses on active labour market policies and the improvement of labour mobility. The persistently very high rate of registered unemployment of 42% (August 2009), the low activity rate and the weak labour market dynamics result primarily from structural rigidities related to the taxation of labour, relatively large and poorly targeted social transfers and the rigid wage-setting mechanisms. Consequently, measures to reduce these rigidities are of utmost importance. The improvement of labour mobility which is to be achieved, inter alia, by a better flow of information between employment agencies at and between local and entity level and a harmonisation of the contribution system, is certainly a significant aspect of this, and so is the reform of the social benefit system in the Federation which is dealt with in another section of both the EFP and this assessment.

2.5.3. Other reform areas

The 2010 EFP highlights two additional reform areas: public administration and pension systems. The reform of public administration plays an important role in improving the fiscal efficiency of the public sector and creating the structures capable of adopting and implementing the *acquis* in Bosnia and Herzegovina. The programme describes the progress made in the implementation of the Action Plan 1 of the Public Administration Reform strategy which is stated to have reached 38% in the third quarter 2009 (up from 28% stated in the previous year's EFP)([21]). It lists 14 projects of which two have been started, without giving an indicative timetable for the remaining ones. In addition, the preparation of the second Action Plan is discussed.

The programme acknowledges the increasing importance of a pension system reform, given demographic developments in Bosnia and Herzegovina which may endanger the sustainability of the current pay-as-you-go systems. The RS is far more advanced as regards pension reforms as the political will for these reforms is low in the Federation. In the RS, a fund is being established that will serve as a second capital-based pillar of pensions, to which a third pillar of voluntary pension funds to which contributions can be made from the personal income will be added. The road taken by the Republika Srpska is promising, while the issue needs to be urgently tackled in the Federation.

2.6. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The presented macroeconomic framework in the 2010 EFP is clearly an improvement to the one of the previous programme. The underlying assumptions are much more realistic than it was the case last year. The recent macroeconomic performance is adequately described and it includes most relevant information available at the time of drafting. While some of the requested data were not provided and the corresponding tables not filled in, it is a clear upgrade of the programme that for the first time a full scenario for the development of external accounts is presented. Other remarks of last year's EFP assessment concerning the presentation and provision of data have not been tackled, though.

Fiscal framework

The medium-term fiscal strategy could have been more clearly elaborated and adequately backed by concrete policy measures, whose economic or fiscal impacts could have been quantified to a larger extent. The link to the presented medium-term economic framework, the overall policy objectives and the country's EU accession agenda is not always clear. The programme refers to some of the European Partnership priorities but mostly does not translate them into concrete policy action. No link is openly

([21]) It remains unclear, though, how these rates are measured.

established to the findings of the Progress Report which do not seem to have explicitly guided the EFP. Key short-term fiscal measures related to the IMF programme are adequately explained but the programme is vague on the medium-term. The presentation of fiscal risks could have been more straightforward and better quantified. Data were processed in compliance with the GFS 2001 accounting standards, representing a good starting point for the transition to ESA 95.

Structural reforms

In general, the privatisation agenda as it is elaborated in the EFP is supportive to the fulfilment of the Copenhagen economic criteria and broadly follows the findings of the Progress Report. However, other structural reform areas are overall insufficiently tackled. In particular, measures to improve the business environment are urgently needed.

3. MONTENEGRO

EXECUTIVE SUMMARY

On 29 January 2010, Montenegro submitted to the European Commission its fourth Economic and Fiscal Programme ("2010 EFP") covering the period 2010-2012. The programme aims at reducing the fiscal deficit as of 2011 to reach a balanced budget by 2012. The programme provides a concise overview of recent macroeconomic developments at the time of submission. Two different scenarios about future macroeconomic developments are presented, based on a comprehensive understanding of the main risks facing the economy. However, data coverage remains weak and there are some discrepancies in the baseline macroeconomic scenario.

The economy was severely hit by the global crisis, contracting by 5.3% in 2009. Domestic demand fell by close to 20% and external trade was reduced by a third as industrial activity declined sharply. As a result, budgetary revenue deteriorated and the overall deficit worsened. After the bank run in late 2008, the financial system remained relatively stable in 2009. The baseline scenario assumes that the crisis will continue to impact the economy in 2010, although private consumption and investment in fixed capital will start to recover. The fiscal deficit is expected to widen further before a consolidation based on recovering revenues and stable nominal expenditure starts in 2011 when the economy is envisaged to be on a growth path again. Overall, the programme's economic growth assumptions seem plausible but labour market projections still look optimistic. At the same time, due to the lack of information on the real growth composition and to some data discrepancies, it is difficult to evaluate fully the envisaged growth profile.

The tax-rich pattern of growth in the past boom years allowed for high revenues and an accommodative fiscal stance, which was severely challenged as the credit crunch resulted in a sharp contraction of private consumption in 2009. A budget rebalance was adopted in July 2009 targeting a deficit of 2.6% of GDP. However, the actual deficit reached 3.5%. The fiscal framework foresees further shifts in the composition of revenues. The share of indirect taxation, the major source of revenues in the past, is set to decline while that of direct taxes and social security contributions would increase. The framework is quite comprehensive and gives a qualitative review of the main fiscal risks already identified in last year EFP, although it fails to point to the future needs for clearing arrears accumulated by local authorities and rescued companies.

Despite the crisis, the structural reform agenda was not only maintained but further accelerated. A large part of the reform agenda is already being implemented according to commitments. The measures also seem largely appropriate and address more than the mere need to deal with the most urgent interventions required by the crisis. The structural reform framework is quite extensive. It could benefit from streamlining and reducing most of the background information on past achievements and rather focus on the concrete future reforms and plans. Despite an effort to evaluate the costs of the different reforms, in some cases at a very detailed level, the programme fails to asses their impact on the budget balance and on the quality of public finances, which also highlights the need for reinforcing the capacity of analysis of the administrations involved in this exercise.

The two scenarios included in the programme are used for both the macroeconomic and fiscal frameworks. They differ on the extent to which the risks that materialised in 2009 will impinge on 2010 as well, or in other words whether a mild recovery or a further deepening of the crisis can be expected this year. Yet, the programme contains some inconsistencies, such as presenting unique inflation and export paths, despite different estimations for growth. The programme lists a comprehensive set of risks, ranging from conditions in the domestic banking sector and on the

international financial markets to dependence of the economy on a limited number of sectors such as tourism and heavy industry.

The programme's reform agenda seems appropriate in view of supporting the fiscal scenario long-term sustainability and largely aligned with the reform requirements originating from the accession process summarised in the European Partnership priorities and the findings of the Commission's assessment of the economic Copenhagen criteria in its last Progress Report. From 2010, structural reforms are being actively advanced as limited fiscal and monetary space was evidenced during the crisis.

3.1. INTRODUCTION

The 2010 EFP of Montenegro, covering the period 2010-2012, was submitted to the Commission within the deadline set for 31 January 2010. The programme was drafted primarily by the Ministry of Finance with input from other public institutions and is linked to the 2009 rebalanced budget, the 2010 budget and the 2010-2012 Medium-term macroeconomic and fiscal frameworks. The programme broadly complies in terms of content and form although some sections could benefit from reducing background information and focusing on concrete measures and their links to both the macroeconomic and the fiscal frameworks. This year submission also presents alternative scenarios although with some inconsistencies. Yet, the EFP would also have benefited from a presentation of the different scenarios with the corresponding tax policy options and confirm the absence of arrears in the budget financing. The quality and availability of statistical data remain weak, impacting on the comprehensiveness of the description of developments. The analysis of the recent and medium-term fiscal developments is based on the national accounting standards, GFS 2001 on a cash basis.

The programme aims at maintaining the fiscal deficit under financeable limits as the economy is not expected to recover firmly before 2011. The planned budget deficit of 4.3% of GDP in 2010 may seem rather conservative, as revenues in 2010 are assumed to be no higher than in the 2009 crisis year. Capital spending is once more given the dual role of stimulating economic activity or acting as fiscal buffer in case revenues fall more than expected. Overall, the programme demonstrates sufficient plausibility to meeting the budget targets in 2010-2012, but the quality of the composition of budget spending may suffer, in particular after the large increases in current spending and commitments witnessed in the past and the difficulties to curb them significantly afterwards. At least, the structural reforms are expected to continue during the programme period as most of them are already engaged.

3.2. KEY POLICY CHALLENGES

The public finances strategy faces a dilemma. On one hand it must contain public spending under financeable levels as revenues have been faltering. On the other hand, fiscal pressure cannot be easily increased without damaging the recovery and fiscal attractiveness of a small country which relies largely on foreign investments.

The main challenge for a very small economy like Montenegro is to find a balanced growth model which does not excessively rely on consumption. Until recently, consumption was boosted by high credit growth as banks were competing for market shares while disregarding excessive risk taking. The financial crisis has put an end to such course and it will take some time before banks sort out their balance sheets and consumption recovers some of its past dynamism. While the tourism sector showed resilience, economic diversification would help to spread risks and avoid a large exposure to a limited number of sectors, including the metal industry. In this respect, ongoing structural reforms seem to follow the right direction as demonstrated by plans to improve the business environment and to invest in energy production and transport.

3.3. ECONOMIC DEVELOPMENTS AND OUTLOOK

3.3.1. Recent macroeconomic developments

Preliminary estimates by the Ministry of Finance show that the economy contracted by 5.3% in 2009. The decline was driven mainly by a drop in the manufacturing and mining sectors, which continued to suffer from low external demand and commodity prices. Investments and households' consumption contracted sharply as well, while net exports and government consumption are expected to have contributed positively to real GDP growth. By the end of the third quarter of 2009, the current account deficit had shrank by more than half in nominal terms, on the back of rapidly falling imports of goods. The surplus in services remained basically unchanged from the previous year as tourism revenues performed rather well in the crisis with a nominal decline of 7%. The capital and financial account was close to balance. Substantial net FDI inflows of about 25% of GDP were recorded in this period, more than enough to cover the current account deficit. Despite the slowdown in economic activity, the average registered employment grew by 4.8% and the year-average recorded unemployment reached 11.4%. These developments came mainly as a result of the strong decrease in non-resident employment. Consumer prices increased moderately throughout the year and inflation averaged 3.4%. Labour productivity worsened while average wages continued to grow, albeit at a lower pace than in 2008.

The 2010 EFP provides a concise overview of recent macroeconomic developments at the time of submission. Nevertheless, data coverage remains weak and there are some discrepancies in the baseline macroeconomic scenario. Like in the previous EFP, different scenarios about future macroeconomic developments are presented, based on a comprehensive understanding of the main risks facing the economy.

Table II.3.1:
Macroeconomic developments

	2008	2009	2010	2011	2012
Real GDP (% change)	6.9	-5.3	0.5	3.5	4.0
*Contributions**:					
- Final domestic demand	42.0	23.9	3.9	3.6	4.8
- Change in inventories	0.1	0.3	-3.1	0.9	0.3
- External balance of goods and services	-35.2	-18.3	-0.3	-1.0	-1.1
Employment (% change)	8.2	4.0	1.5	3.0	5.0
Unemployment rate (%)	10.7	11.4	n.a.	n.a.	n.a.
GDP deflator (% change)**	11.8	5.3	3.3	3.0	3.5
CPI inflation (%)	7.4	2.8	2.0	3.0	3.0
Current account balance (% of GDP)	-32.6	-16.5	-16.3	-15.4	-15.4

Sources: Economic and Fiscal Programme 2010

* *The GDP deflator has been used to calculate real contributions*

** *Implicit GDP deflator*

Source: EFP 2010 submission, own calculations

Box II.3.1: **The global economic crisis: First impact and policy response**

The Montenegrin economy has been severely hit by the global economic crisis. Domestic demand contracted by close to 20% in 2009 and external trade was reduced by a third. Industrial activity declined by more than 30%, led by mining and quarrying which by the end of 2009 was running at less than 20% of its 2008 average. Manufacturing, especially of primary metals and metal products was severely affected as international prices of aluminium and steel remained well below their pre-crisis levels. As a result of falling economic activity, budgetary revenues deteriorated and the overall deficit worsened. After commercial banks had to cope with a massive deposit withdrawal in late 2008, the financial system remained rather stable in 2009. Nevertheless, domestic credit and deposits remained below their pre-crisis level. The EFP's baseline scenario is built on the assumption that the crisis will continue to impact the economy in 2010, although private consumption and investment in fixed capital will start to recover. The fiscal deficit is expected to widen further before consolidation based on recovering revenues and stable nominal expenditure starts in 2011 when the economy is envisaged to be on a growth path again.

In response to the crisis, the authorities adopted in October 2008 a law containing measures to ensure the stability and liquidity of the banking system, including a full guarantee of domestic deposits, provision of liquidity to banks through early debt repayment, recapitalisation by purchase of shares and provision of guarantees for the facilitation of an inter-bank market. The authorities also adopted a programme of reduction of electricity prices for the most vulnerable categories of the population, as well as for small and medium enterprises (SME). In 2009 the authorities adopted additional measures to boost the liquidity of the banking system by provision of state guarantees for credit lines to the banking sector, and further ease the provisioning rules and mandatory reserves.

In 2010 the government is planning additional measures to alleviate the crisis impact on the economy. Measures include a further reduction in personal income tax and contributions paid by employers, setting aside funds for improving the road infrastructure and transportation, and continuing with the privatisation process. The programme provides estimates of the budgetary impact of these measures. The overall level of the 2010 budget expenditure is not impacted significantly and is estimated to remain close to the previous year outcome.

3.3.2. Medium-term macroeconomic scenario

The impact of the global economic crisis on the economy has been higher than expected in the previous year's EFP, which led to significant revisions in most of the economic indicators with the submission of the 2010 EFP. The baseline macroeconomic scenario envisages a modest real GDP growth in 2010 and a mild recovery starting only in 2011. An alternative "crisis" scenario, assuming continuation of the economic contraction in 2010 has been presented as well. The external outlook of the EFP is based on forecasts by the IMF and the EBRD from October 2009. Domestic demand, households' consumption in particular, is expected to drive economic growth. Investments growth is set to be only marginally higher than the growth in private consumption, leading to a negligible rise in their share in GDP. According to the baseline scenario, net exports and the current account deficit to GDP are forecasted to remain basically unchanged, at their 2009 levels. Price pressures are subdued and growth in employment accelerates from 2010 onwards.

The programme's baseline economic growth assumptions seem plausible but labour market projections look optimistic. At the same time, due to the lack of data on the real growth composition and some data discrepancies, it is difficult to evaluate fully the envisaged growth profile. The EFP benefits from the presentation of an alternative scenario, which is more pessimistic on the speed of economic recovery. The main risks to the macroeconomic scenario are clearly defined, although the programme could have been more explicit on its links with the fiscal scenario.

Real sector

The baseline macroeconomic scenario foresees a continuing impact of the global economic crisis on the local economy in 2010 when it is expected to grow only by 0.5%. The pick-up in economic activity in 2011 and 2012 is conditioned mainly on a recovery of domestic demand. Private consumption's share in GDP is set to expand already in 2010 to 73-74% and to remain stable afterwards. After a nominal increase of about 33% in 2009, which remains unexplained, public consumption is expected to slowly reduce its share in GDP. Gross fixed capital investment is forecasted to recover slowly and increase its share in GDP by 2 percentage points to 16.7% over the programme horizon. The underlying assumption for the GDP growth profile is that external imbalances will remain broadly unchanged at their 2009 level, while the process of deleveraging and reduction of domestic credit activity will continue. Both, wages and employment are expected to grow and support the rise in private consumption. The claim in the programme that labour productivity will increase throughout the period is not well founded and does not match the data. On the supply side, the EFP envisages that the recovery will be driven by the agriculture, industry and construction sectors, at the expense of services. Overall, while the headline assumption of the real GDP growth profile seems realistic, the growth composition may not be sustainable as it is skewed heavily towards private consumption and relies on raising employment and wages.

The alternative or "crisis" scenario differs from the baseline mainly in its assumption of a bigger (-2%) real GDP contraction in 2010. It results from more cautious private consumption and investment projections. Yet, the programme could have elaborated more on the differences between the two scenarios and the different patterns of growth that they presumably represent.

Inflation

The use of the euro provides a high level of price stability in Montenegro. Domestic prices are influenced heavily by developments on international commodity markets. The economic crisis has had a pronounced disinflationary impact and the monthly annualised inflation dropped to 1.5% by the end of 2009. In 2010, the EFP foresees a 2% inflation rate, which would further accelerate to 3.0% in the outer years of the programme. An identical inflation path is presented in both scenarios despite different estimations for growth. In the context of the uncertain recovery of the global economy and the likelihood of a lower labour demand and downward pressure on wages, the risks to price stability appear to be balanced.

Monetary and exchange rate policy

The country's unilateral euroisation implies that there is only limited scope for the use of domestic monetary instruments. Since late 2008, when there was a significant deposit withdrawal, the main financial indicators of the banking system have worsened. Deposit and credit growth turned even negative, non-performing loans increased and the banking system started to generate losses. The EFP presents a number of measures that have been taken by the Central Bank to alleviate the impact of the crisis. They concern risk management, capital adequacy and mandatory reserve requirements and in principle provided more favourable conditions for credit restructuring, asset classification and calculation of provisions. The banking system continues to be dominated by foreign-owned banks (10 out of 11). In the crisis, parent banks extended support to their subsidiaries in Montenegro. Nevertheless, recent central bank estimates point at the need of further recapitalisation efforts in 2010. The programme outlines a number of further actions directed at strengthening the capacities of the Central Bank and improving the legal framework in the field of financial supervision, which remains very important in ensuring the overall financial stability.

External sector

Montenegro is a small and open economy. Growth depends on its ability to export and to attract foreign tourists and capital. The economic contraction is estimated to have reduced the overall trade in goods and services by about a third and to have led to a significant decrease in external imbalances in 2009. The current account deficit halved mainly as a result of a 40% drop in the imports of goods. The programme foresees that both exports and imports of goods and services will start to recover as of 2010. At the same time, the overall trade and current account deficit are expected to remain broadly unchanged over the programme horizon, at levels of about 30% and 15% of GDP, respectively. As a result of the crisis, the degree to which domestic demand is satisfied by imported goods and services is implied in the programme to have fallen dramatically by 14 percentage points to around 43% in 2009. This ratio is set to increase only marginally to 45% in 2012 as the economy recovers.

Even during the crisis in 2009, Montenegro continued to benefit from exceptionally high FDI inflows. The programme expects net FDI to have totalled at about 25% of GDP in 2009, to which the partial privatisation (44%) of the electrical power company contributed more than 11% of GDP. In the period 2010-2012 the EFP envisages FDI inflows in the range 13-16% of GDP. The programme does not explicitly specify the expected profile of these investments, on which basis the plausibility of this assumption can be judged. It is important to note though, that it may be increasingly difficult for Montenegro to continue to attract FDI in the pre-crisis boom sectors like tourism and construction. Overall, the EFP does not present a complete medium-term financial and capital account scenario. There is no significant difference between the baseline and the "crisis" scenario in terms of external sector developments, and the potential for goods exports appears optimistic.

Main risks to the macro-economic scenario

The programme outlines and gives a qualitative review of the main risks to the macroeconomic scenario. This analysis is based on the risks that have already been identified in the previous EFP. It also includes a brief description of whether the respective risks materialised in 2009 and differentiates between the two macroeconomic scenarios on the basis of the extent to which risks are expected to materialise in 2010. Yet, the EFP would also have benefited from a presentation of the different scenarios with the corresponding tax policy options and confirm the absence of arrears in the budget financing. Despite the relatively detailed risk assessment, the document lacks a certain degree of consistency between it and the actual macroeconomic and fiscal framework presented in the programme. For example, a baseline scenario risk of a budgetary cost in excess of 1% of GDP due to increased unemployment is not incorporated in the budget scenario. The programme would have benefited from clearly establishing the links between all risks and the macroeconomic and fiscal framework, for instance, the link between the vicious circle of credit crunch, increasing illiquidity in the real sector and the accumulation of inter-company debt and their combined impact on potential growth.

3.4. PUBLIC FINANCE

The fiscal framework foresees further shifts in the composition of revenues. The share of indirect taxation, the major source of revenues in the past, is set to decline while that of direct taxes and social security contributions would increase. The current framework is quite comprehensive. Key fiscal measures are presented, including some broad quantitative estimates for most of the measures. The table with the analysis of fiscal risks is particularly detailed, and this kind of presentation should be encouraged in future exercises. The programme offers two basic scenarios (basic / crisis) for macroeconomic, fiscal and for debt risks. Yet, there are some inconsistencies of some basic indicators between the scenarios and between different chapters. Fiscal data is still based on GFS 2001 accounting standards on a cash basis.

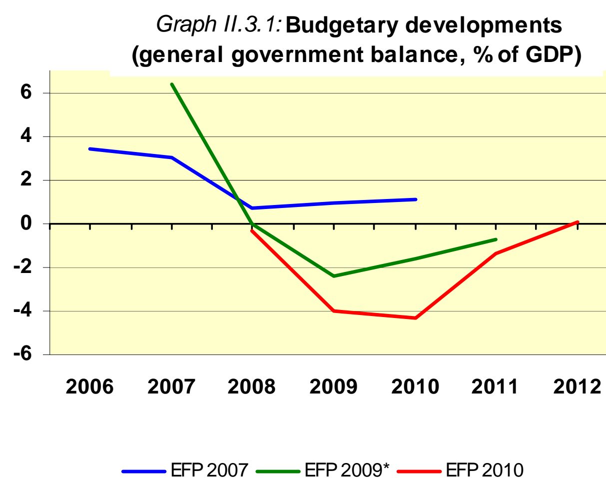
3.4.1. Budget implementation in 2009

The tax-rich pattern of growth witnessed during the recent boom years, which was highly dependent on indirect taxes and allowed for an accommodative fiscal stance was severely challenged as the global crisis hit the economy in the last quarter of 2008. The sudden halt of banks credit in October 2008 resulted in a sharp contraction of private consumption and merchandise imports affecting the whole 2009, and thus led to the abrupt reduction of incomes from VAT (-16% since December 2008) and from customs duties (-33%). The deceleration of the economy along 2009 also impacted all other taxes and contributions with the exception of excises on tobacco and mineral oil products which were raised and recorded positive growth (7%).

The EFP does not describe in much detail budgetary developments in 2009. The original budget which foresaw a small surplus of 0.1% of GDP was based on optimistic macro assumptions and included an increase in expenditures of 9.1%. The deterioration of fiscal revenues (-14% in 2009) finally led to its revision in July 2009. The amended budget targeted a deficit of 2.6% of GDP. However, according to the latest estimates, the actual deficit is expected to exceed the planned level and reach 3.5% of GDP, as the reduction of public spending proved insufficient to offset falling revenues. After large increases in public spending in 2008, especially in public wages (30%) and pensions (10%), some efforts were made in the 2009 budget revision to reduce some of the most flexible expenditures. With regard to current expenditures, wage allocations (i.e. the non-compulsory part of the salary) were reduced by 6% and consumption of goods and services by 2% after keeping maintenance at a strict minimum level (-77%) while social transfers increased as a result of the anti-crisis measures (e.g. electricity subsidies for poor families). Capital expenditures were also reduced (-5%) though the most important infrastructure projects were maintained.

Apart from the higher excise rates on tobacco and oil products implemented in October 2009, no fiscal adjustment measures were taken to compensate for the falling revenues. The lowering of income tax rates that started in 2007 was continued in January 2009 with a reduction of 3 percentage points.

Graph II.3.1: **Budgetary developments (general government balance, % of GDP)**



* As from 2009 the Economic and Fiscal Program is presented end-January, instead of December (2008)

3.4.2. Medium-term budgetary strategy

The EFP identifies the main risks to the fiscal medium term framework and, thanks to the alternative scenario, provides a comprehensive budgetary overview.

Box II.3.2: **The budget for 2010**

* The draft budget for 2010 was approved by the government on 29 November 2009 and adopted by the parliament on 17 December.
* The budget presents a fiscal deficit of 4.2% of GDP.
* Several amendments to the tax regime were introduced along with the budget, amending the personal income tax, the corporate income tax, social security contributions, as well as removing former exemptions to the tax regime, like on public wages stipends, on usage of vehicles, and on capital gains.
* Institutional changes or accounting changes do not affect the budgetary outcome significantly, as all the extra-budgetary funds were already integrated into the single treasury system in 2009. However, given the significant contraction of GDP in 2009, data expressed in percentages of GDP should be considered carefully. For instance public debt, while remaining at the same nominal level of EUR 1.14 billion rises from 35% of GDP to 37% because of the denominator effect.

Table: Main measures in the budget for 2010

Revenue measures*	Expenditure measures**
• Amendments to the **excise** law*** on oil products and tobacco (0.6% of GDP) • Reduction of exemptions on **usage of vehicles** and vessels (0.1% of GDP) • Amendments to **social security contributions** (0.5% of GDP) • Reduction of the **personal income tax** flat rate (-0.6% of GDP) • The programme also considers increasing **VAT** rate by 1 percentual point (0.6% of GDP), although without specifying under which circumstances.	• Cuts on public **wages** (0.5% of GDP) • Other current expenditure **savings** (0.6% of GDP) • Reduction of **capital budget** (1% of GDP)

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
*** Measure introduced in October 2009, impact estimated for 2010 budget

The programme envisages a budget deficit of 4.3% of GDP in 2010, in line with the 4.2% foreseen in the 2010 budget adopted by Parliament on 17 December 2009. The macro economic assumptions are those of the EFP "base scenario", namely a mild recovery in 2010 with an economic growth of 0.5% and an average inflation of 2%.

The EFP does not provide much detail on the 2010 public finances and somewhat differs from the 2010 adopted budget. However, in both cases, fiscal revenues are expected to be low and consolidation results from the nominal stability of public spending. Yet, despite some spending reduction in real terms, there is no improvement of the deficit in 2010 but a further deterioration when compared with the 2009 outcome.

Total revenues in the 2010 budget amount to EUR 1.34 billion. Out of these, EUR 795 million are expected from tax receipts, taking into account the full year effects of the increase in excises in October 2009. Tax revenues from personal income tax and corporate income tax will decline by 12% and 9% respectively over the year, as the income tax flat rate is further reduced to 9% (down from 12%), and economic activity is stagnant. By contrast, social security contributions are estimated to rise by 5%, reaching their 2008 pre-crisis level as a result of the changes introduced into the social security insurance. The reduction to 10% of the contribution rate of employers to the pension and disability insurance will be offset by a percentage increase of a similar magnitude (3pp) for employees. The changes in the contributions for health insurance (2pp rise for employees and 1.2pp cut for employers) will have a positive net effect on social security revenues.

The 2010 budget foresees stagnation in nominal terms of total spending at EUR 1.48 billion. Current spending would decrease mainly as a result of wage restraint. Wages in the public sector would be reduced by 3 to 7% and further through the implementation of various measures of the new law on wages of civil servants (e.g. part-time employment and pre-redundancy provisions). The programme would have benefitted from a more transparent compilation of these measures and of their impact in a recapitulative table. The share of capital spending is set to remain around 16% of the total consolidated expenditures in 2010. The objective of the 2010 budget is to finance current expenditures by current revenues, any deficit being the consequence of capital spending financing (i.e. golden rule).

Table II.3.2:

Composition of the budgetary adjustment (% of GDP)

	2008	2009	2010	2011	2012	Change: 2009-12
Revenues	50.1	43.1	41.9	42.1	41.1	-2.0
- Taxes and social security contributions	38.6	33.9	33.9	34.1	33.1	-0.8
- Other (residual)	11.5	9.2	8.0	8.0	8.0	-1.2
Expenditure	50.4	47.1	46.2	43.5	41.1	-6.0
- Primary expenditure	49.6	46.3	45.2	42.5	40.1	-6.2
of which:						
Gross fixed capital formation	10.1	6.9	7.3	6.9	6.8	-0.1
Consumption	18.8	17.8	17.0	16.1	15.1	-2.7
Transfers & subsidies	12.1	15.0	14.1	13.2	12.2	-2.8
Other (residual)	8.6	6.6	6.8	6.3	6.0	-0.6
- Interest payments	0.8	0.8	1.0	1.0	1.0	0.2
Budget balance	-0.3	-4.0	-4.3	-1.4	0.0	4.0
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	0.5	-3.2	-3.3	-0.4	1.0	4.2
Gross debt level	29.0	35.2	39.5	38.7	34.2	-1.0

Sources: Economic and Fiscal Programme 2010, ECFIN calculations

The main goal of the EFP is to reduce the fiscal deficit and reach a balanced budget by 2012. For the next two years, the baseline fiscal scenario assumes a recovery in the growth of nominal revenues (7% in 2011 and 5.2% in 2012), stabilising their level at 41%-42% of GDP. Fiscal consolidation is the result of public spending increasing at a much slower pace than revenues (by 0.4% y-o-y in 2011 and by 1.5% in 2012), thus reducing the budget deficit from -4.3% of GDP in 2010 to -1.4% of GDP in 2011, to reach equilibrium in 2012. Capital spending would remain stable at close to 7% of GDP. After having remained at around 40% of GDP in the last four years, the share of current expenditures could fall below 35% of GDP by end 2012.

This year's programme takes a very pragmatic approach, considering that fiscal outcomes will be somewhere between the results of the two macroeconomic scenarios. The fiscal risks listed in the programme stem from several economic sectors – from heavy industry to tourism and financial intermediation. Moreover, risks are also contemplated on the demand side due to reduction of public spending and rising unemployment. Finally, a third group of risks concerns budget financing in case

of failure of the privatisation programme, the planned issuance of sovereign debt on the international financial markets, and the future needs for clearing arrears accumulated by local authorities and rescued companies.

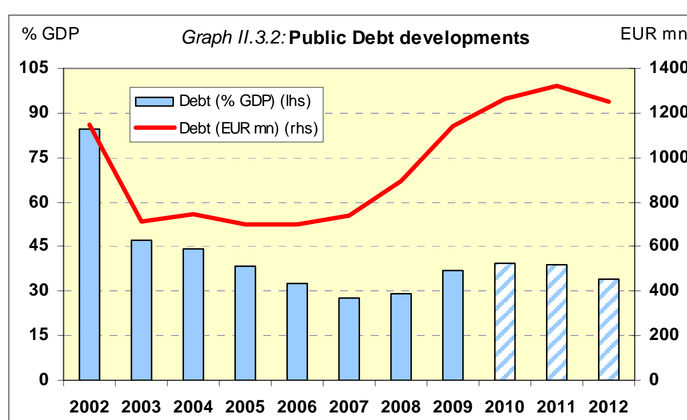
Budgetary implications of "major structural reforms"

Although the programme provides a broad overview of the budgetary impact in 2010 of structural reforms in several areas, it could have benefitted from their inclusion into a comprehensive table. For 2010, the programme foresees revenues from privatisations close to 2% of GDP. The reform of the tax system by further lowering tax rates paid by employers will have a cost of 0.5% of GDP. The improvement of infrastructures will consist mainly of several road works planned for 2010 for a total amount close to 2% of GDP. However, the recent cancellation of negotiations with the first ranked bidders to build the Bar-Boljare highway may result in savings of half that amount in 2010. Modifications of the law on foreigners, providing them the same rights as local workers, but also the same contributive obligations, will broaden the tax base with an estimated positive net effect of half a point of GDP. Overall, these reforms are likely to contribute to the improvement of the country's growth potential.

3.4.3. General government debt

The programme presents a very detailed situation of the public debt and the reasons underlying its evolution. The public debt increased rapidly and significantly in 2009 to 37% of GDP from 29% a year earlier due to the simultaneous increase of domestic and external borrowings. The domestic debt increased in nominal terms by 6.5% in 2009 as it continued servicing the compensation of due pension rights and the state's liability on frozen foreign exchange deposits, but also the transfer to the government of the railways company debts in view of its restructuring and privatisation. In the medium term, both the basic and crisis fiscal scenarios surprisingly consider a stabilisation of debt levels. Both scenarios project a further increase in public debt to 39.5% of GDP in 2010 and a decrease in GDP terms during the following years as the economy recovers. Total public debt should thus amount to some 34% of GDP by 2012. Yet, these projections do not take into account contingent liabilities from state owned enterprises, which currently represent an additional EUR 124 million (or 4% of GDP).

Graph II.3.2: **Public Debt developments**



The currency structure of the debt is rather favourable as most of the debt obligations are denominated in euro, and some 77% of total debt bears fixed interest rates. Moreover, the domestic debt bears an interest rate of about 2% and interest payments are at the sustainable level of 1% of GDP in the budget. Yet, the increase of public debt reflects the deterioration of the budget balance, and the recourse to expensive loans from foreign commercial banks to finance the public deficit. While the interest structure was beneficial with most of the external debt on concessional terms with interest

rates between 2 and 5.8%, the two recent loans for budget financing in 2009 for a total of EUR 90 million bear annual interest rates of 8.4% and 9%. Therefore, the government plans to issue Eurobonds for up to EUR 200 million for financing the 2010 budget. However, the rapidly rising contingent liabilities of the loan guarantees to sectors in difficulty and the metal industry in particular could disrupt the projected public debt path in the medium term.

3.4.4. Quality of public finances and institutional features

Other structural measures have also been considered to further guarantee the long-term sustainability of public finances, although some of them seem rather vague and speculative. This is for instance the case of the pension reform and the introduction of a mandatory funded scheme, a study being announced in 2010. More concrete is the announcement of the integration of the Pension Fund and the Health Insurance Fund into the Treasury in 2010 to increase the transparency of the budget. Meanwhile, the Development Fund is being transformed into a self-financing state investment fund and removed from the consolidated budget. Further reform of the education and health sectors will be performed through public private partnerships schemes which are not detailed at all.

Overall, the programme addresses the issue of improving the quality of public finances through the changing structure of both revenues and expenditures in the budget. On the revenue side, the reduction of the fiscal burden should help to stimulate private consumption thanks to the reduction of the personal income tax rate from 12% to 9%. Simultaneously, the reduction of employer contributions by almost 7 percentual points is intended to help the productive sector. Future budgets will thus need to rely on the broadening of the tax base and on a more dynamic economy to ensure a new equilibrium. On the expenditure side the most important adjustment comes from statutory changes with a view to cutting the wage bill and restraining its growth path in the future. However, while the objective of reducing the tax burden has been consistently pursued, that of curbing the level of current public spending has been continuously postponed. Capital spending is kept at a significant level and could, through the improvement of public infrastructures, support future growth, notably for all activities related to tourism and transport.

3.5. STRUCTURAL REFORMS

Despite the crisis, the structural reform agenda was not only maintained but further accelerated with the twin objective of restructuring and stimulating businesses and setting the basis for a stronger recovery. A large part of the reform agenda is already being implemented. The measures also seem largely appropriate addressing more than the mere need to deal with the most urgent interventions required by the crisis. The programme could certainly benefit in future exercises from a brief summary listing systematically the main measures, their timetable and their estimated impact on the budget. Though efforts to list the estimated cost of every measure should be recognised, the rather disorderly approach undertaken does not lead to any overview or aggregated estimations. The contributions provided by the different administrations would benefit from a general review and their integration with the different chapters of the programme, for instance by cross-referencing them with the well detailed table describing the two-scenario risks.

3.5.1. Product and capital markets

The privatisation and restructuring programme shows mixed results so far. While the partial privatisation of the electric power company together with the opening of the transmission electricity market in 2009 were successful, some companies slated for privatisation failed to attract investors' interest. While transport industries (railways, port, airways) are being transformed in view of their privatisation, the restructuration of the metal sector (aluminium and steel) is primarily focused on the survival of the sector. Meanwhile, the support to SME is being implemented through active policy

measures like business incubators and the establishment of an Investment Development Fund to guarantee SMEs operations, although practical details remain unclear. Other reforms include the establishment of an agency for the safeguard of competition and the adoption of public procurement regulations. To enhance business environment, a Regulatory Reform Project will undertake a systematic revision of regulations to eliminate unnecessary legislation and shorten procedures (i.e. regulatory guillotine) and will introduce regulatory impact assessments. The telecommunications sector, already well developed, is undergoing a series of technical upgrades and further improvement will rather focus in streamlining regulatory aspects.

After the extraordinary revenues recorded in 2009 from the privatisation of the electric utility (some 3% of GDP), the programme estimates receipts from sale of public assets to dwindle progressively in the years to come, and to remain at some 1.5% of GDP annually, which seems prudent considering the still uncertain international economic environment. The support for restructuring the metal industry, mostly through subsidies is estimated at 1.5% of GDP, while state guaranteed loans to the same sector amount to an additional 1.5% of GDP. Yet, the programme does not evaluate whether the social returns clearly exceed these costs. The establishment of the Agency for Protection of Competition and the implementation of the regulatory guillotine projects will have an estimated fiscal impact of some EUR 300 thousand per year each. However, the benefits for the business environment will be much larger. Overall, all these reforms will certainly have a positive impact on the future economic prospects of the country. Most of them are already underway and the main risk would stem from delays in their implementation.

The impact of the crisis on the banking sector resulted in a series of reforms of the legal framework with a view to preserving the stability of the sector. One of the most important was the Law on the Supporting of the Banking System, providing a blanket guarantee for the whole amount of deposits. A new law on the protection of deposits will provide for an initial coverage of EUR 20,000 per depositor in 2010, to progressively reach EUR 50,000 in 2012 thus not covering the full amount of deposits any longer. In order to cover these obligations, the government subscribed a stand-by credit line with the EBRD. During 2009 the central bank adopted a set of secondary legislation with the common objective of increasing banks' liquidity. Commercial banks are also benefiting from the loan guarantees subscribed by the government to finance SMEs' projects. In April 2010 a new legislative package amending the Deposit Protection Law, the Law on Banks and the Law on Bank Bankruptcy and liquidation will be submitted to Parliament for adoption. With the privatisation of the local insurer Lovcen Osiguranje, the financial sector has been completely privatised. A merger of the two stock exchanges operating in the country could also be expected in 2010. Overall, reforms are focused on strengthening the institutional capacities of both the insurance and capital market regulators and alignment of laws with EU legislation. The EFP provides a detailed list of bank legislation as well as the implementation calendar.

3.5.2. Labour market

The programme presents a series of reforms, mostly active labour market measures in favour of employment, e.g. training courses organised by the Employment Agency at the request of employers or loans for self-employment. Since 2009 these active measures have been more focused on the poorer North region, with a view to reducing regional differences, and also to supporting vulnerable minority groups. The employment programmes are also increasing efforts to address the issue of structural unemployment (i.e. to address the skill mismatch). A major novelty has been the establishment in 2010 of a Labour Fund whose main task is to clear the obligations of insolvent and liquidated companies towards their workers. This institution will guarantee that workers will receive the salaries owed by the employer in case of bankruptcy of their company. Another is the memorandum on social partnership in the global crisis between the members of the Social Council, by which during the crisis employers engage themselves not to lay off workers while the trade unions engage not to organise strikes. Overall, the programme does not satisfactorily explain their expected impact on employment.

3.5.3. Other reform areas

The programme also lists a series of goals and reforms in the field of social insurance to be implemented through public-private partnership, but does not provide concrete information. The EFP also mentions a strategy for poverty reduction, although it fails to explain how a better targeting of social allowances will be achieved. These welfare measures will have an impact on the budget for years to come, yet there are no estimations in the programme at this early stage.

3.6. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The 2010 EFP provides a concise overview of recent macroeconomic developments at the time of submission. Nevertheless, data coverage remains weak and there are some discrepancies in the baseline macroeconomic scenario. Like in the previous EFP, different scenarios about future macroeconomic developments are presented, based on a comprehensive understanding of the main risks facing the economy.

Fiscal framework

The fiscal policy presented in the programme, and notably the section on fiscal anchors, presents a very clear and sound list of objectives (current spending below 35% of GDP, primary surpluses above 2%, constant capital budget, etc.) to achieve a solid and sustainable fiscal position. However, they have not been implemented in the past. Furthermore, the primary surpluses presented in the tables are below the 2% level recognised as optimal in the fiscal anchors section. Overall, the systematic back-loading of consolidation efforts and pro-cyclical spending during favourable times can raise doubts on the efficiency of the current programme.

Formally, the chapter on public finances lacks consistency and reveals some discrepancies which points to a lack of coordination of the subsections. Key measures are broadly explained although they sometimes remain vague. There is scope for significantly improving the supporting statistics and consideration should be given to the transition towards the European System of Accounting ESA 95.

Structural reforms

The structural reform framework is quite extensive and could benefit from streamlining and reducing most of the background information to concentrate on future concrete reforms, their coordination, consistent presentation, time schedules and estimated impacts on the budget.

4. SERBIA

EXECUTIVE SUMMARY

The Serbian Economic and Fiscal Programme (hereinafter the programme), covering the period 2010-2012, was submitted on 28 January 2010. The programme strives at sustaining macroeconomic stability and containing the fiscal slippage, in particular, through containing the public sector wage bill and pension expenditure as well as improving public administration. The programme broadly complies with formal and data provision requirements. The document could help to align the country's policy mix with the economic conditions and the country's orientation towards meeting the economic Copenhagen criteria for EU membership.

Given the repercussions of the global crisis on the economic situation and outlook, Serbia's economic stabilisation and recovery has been supported by an IMF Stand-By Arrangement (SBA) since January 2009. Serbia has shown a satisfactory track-record in the implementation of the ongoing SBA. The macroeconomic and structural policy agenda presented in the programme is largely based on the economic stabilisation and reform programme endorsed by the national authorities in agreement with the IMF. Concerted donor assistance has aimed at supporting economic stabilisation.

The programme gives a clear and concise picture of past economic developments and a sufficiently comprehensive and consistent medium-term scenario but does not provide alternative scenarios. GDP shrank by 3% in real terms in 2009 as domestic demand waned. However, as the global economy recovers, the economic activity is to pick up from this year (1.5%) and to accelerate to 5% by 2012. Cyclical conditions are likely to improve gradually so that a disinflationary path is expected to be sustained over the medium term. The balance of payments position has improved thanks to the narrowing of the current account deficit, IMF funding and the agreement with the foreign parent banks. The labour market, however, is expected to remain very weak. The growth assumptions do not include the impact of a structural reform plan, which may accelerate growth above the projected rates. The programme's macroeconomic scenario, which continues to be based on a domestic-driven growth model despite the more recent aspirations for a shift to a more export-based growth paradigm, appears broadly plausible. The latest developments have signalled that the economic recession has bottomed out, however, the pace of recovery will be gradual and fragile. While risks are largely related to uncertainties with the global economic revival, some major downside risks are nevertheless predominantly domestic, related to the commitment of the authorities to implement the economic policy reforms announced under the SBA agreement.

The public finance scenario is broadly adequate: it gives a good overview but is yet to illustrate the effects of the planned policy measures. In 2009, the general government deficit is estimated to have reached 4.2% of GDP which is slightly below the anticipated deficit of 4.5%, planned under the supplementary 2009 budget which was adopted in June 2009 in line with the agreement with the IMF. The medium-term fiscal strategy is geared to reducing the general government deficit from 4.2% to 2.4% of GDP by downsizing and restructuring the general government expenditure. Compared with the previous programme, the new strategy proposes considerably less ambitious fiscal targets against a significantly more unfavourable macroeconomic scenario. The consolidation is expenditure-based, to be materialised through decreasing the share of general government expenditure by 2.2% of GDP by 2012. To that end, the programme announces the extension of the current expenditure measures while capital expenditure is planned to increase by 0.4% of GDP. Over the programme period, the general government revenue ratio is expected to fall by 0.4 percentage points to 38.3% of GDP despite the anticipated strengthening of private consumption. Public debt is expected to rise but remain contained at below 35% of GDP. The risks attached to the budgetary targets are broadly balanced. However, the

proposed fiscal consolidation is contingent on the government's commitment on reducing current expenditure. The high share of mandatory expenditure (around 90% of the overall outlays) is rooted in the rigid regulatory framework, which awaits political consensus to be restructured in a more flexible way. Should the cut in current expenditures not materialise fiscal sustainability will be seriously undermined given the plans to increase spending on public investment in the face of the anticipated reduction of revenues. To that end, speedy structural reforms in the area of pension and health systems and public administration aimed, in particular, at reducing the pension and wage bill are key. A decision on when and how to reinstate indexation for public sector salaries and pensions will be crucial for delivering on the proposed fiscal adjustment.

The programme presents a comprehensive structural reform framework, covering a wide range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. Clarifications on how to further develop the private sector would have been welcome, in view of the need to foster a shift in Serbia's economic growth paradigm towards a more export-driven economy and higher domestic savings to finance public investment. The programme confirms the policy priorities but does not provide detailed roadmaps for reform over the medium-tem. In particular, structural reforms that are crucial for enhancing the role of private sector and may also have sizeable budget effects, such as enterprise restructuring and privatisation as well as establishing regulation for a business-friendly environment, need to be prioritised. The programme would have benefited from the presentation of clear timetables for the implementation of the most important structural reform measures.

The programme's reform agenda is largely consistent with the fiscal scenario and largely aligned with the reform requirements in view of the country's European Partnership priorities originating from the implementation of the Stabilisation and Association Agreement, as spelled out in the latest Progress Report and the European Partnership. The programme's overall policy response to the financial crisis has been appropriate, timely and targeted as well as in line with the country's medium-term fiscal sustainability.

4.1. INTRODUCTION

The Serbian Economic and Fiscal Programme for 2010-2012 was submitted on 28 January 2010, following the adoption by government on 1 December 2009.

The programme is an update of the Memorandum on the Budget and the Economic and Fiscal Policy which is a strategic economic policy document in the budgetary process as stipulated in the Budget System Law. It sets out a revised macroeconomic and fiscal policy framework for the 2010-2012 period based on the supplementary budget for 2009 and the 2010 budget bill which were adopted by parliament in December 2009. The programme also responds to the EU guidance related to Serbia's challenges in the accession process, as identified in the 2009 Progress Report.

4.2. KEY POLICY CHALLENGES

The key medium term challenge for Serbia will be to ensure a sustainable macroeconomic and financial environment conducive to growth, job opportunities and an increase in living standards. Fiscal policy will have a major role to play. In this respect, the programme aims at putting in place a more comprehensive, integrated medium-term planning and budgeting framework (cross-sectoral public expenditure management reforms) which will help to improve the composition of public spending and further fiscal sustainability in the long-run.

The programme thus tends to respond to the conclusions of the November 2009 Progress Report where measures to improve medium-term public finances were considered as largely insufficient. Due to limited progress towards establishing a functioning market economy Serbia was also invited to make further efforts in advancing with the structural reforms, in particular accelerating privatisation of state-owned enterprises.

4.3. ECONOMIC DEVELOPMENTS AND OUTLOOK

4.3.1. Recent macroeconomic developments

The programme presents a clear and concise picture of past economic developments and covers all relevant data available at the time of submission. The impact of the global economic and financial crisis on the key macroeconomic aggregates is analysed and a list of anti-recession measures taken in response is provided while the effects of the measures can be sporadically identified in the reporting on macroeconomic developments.

Severely strained by the impact of the global recession, Serbia’s GDP shrank by 3% in real terms in 2009. Economic growth turned negative as domestic demand, which was the driving force of the economy over the past year contracted very substantially, with investment estimated by the authorities to fall by more than 20% and private consumption by over 5%. Trade was also significantly affected but as imports fell faster than exports, the traditionally large current deficit narrowed more than expected, down to 5.7% of GDP from 17.1% in 2008. Nevertheless, the merchandise trade deficit remained relatively high at slightly over 15% of GDP (down from above 20% in 2008). Inflation has been one of the highest in the region.([22]) After a hike in 2007 and early 2008 which propelled the average CPI inflation back to double digit at 12.4% for 2008, inflationary pressures eased somewhat during 2009 thanks to lower oil and food prices, in line with the general price developments in the global markets. By the end of 2009, CPI inflation declined to 6.6% y-o-y (8.6% in 2008) which was

([22]) The Statistical Office has just recently started releasing CPI inflation since 2007.

mainly due to low aggregate demand following the freeze of wages while the pass-through of the exchange rate depreciation has been limited. Given the poor economic growth performance labour market remained very weak. By the end of the third quarter of 2009, the unemployment rate has risen to17.4%([23]) and was one of the highest in the region. Following the nominal freeze of wages in the public sector, net wages decreased last year (3.7% y-o-y in real terms compared to an almost 5% rise in 2008).

Table II.4.1:

Macroeconomic developments

	2009	2010	2011	2012
Real GDP (% change)	-3.0	1.5	3.0	5.0
Contributions:				
- Final domestic demand	-10.7	2.2	4.6	7.9
- Change in inventories	-0.1	-0.1	-0.3	-0.1
- External balance of goods and services	7.7	-0.6	0.0	-2.7
Employment (% change)	-4.6	0.0	0.5	1.1
Unemployment rate (%)	17.4	n.a.	n.a.	n.a.
GDP deflator (% change)	9.1	5.4	5.0	4.0
CPI inflation, average (%)	8.1	5.1	5.2	4.2
Current account balance (% of GDP)	-5.7	-9.0	-10.5	-12.6

([23]) The number refers to the age group 15-64 as per the international convention. The national Statistical Office reports the unemployment rate for people aged 15 and above based on the Labour Force Survey (LFS); at end-October it stood at 16.6%.

Box II.4.1: The global financial crisis: impact and policy response

Since the second half of 2008, Serbia has been affected by the international financial and economic crisis with declining output, increasing pressure on public finances in part due to falling fiscal revenue and rising external financing needs. The Serbian authorities initially adopted measures aimed at mitigating the effects of the crisis on the real sector of the economy by designing a sizeable stimulus package of loans and guarantees in the total amount of almost EUR 300 million (providing about EUR 100 million of direct and EUR 195 million of indirect government subsidies for concessional bank loans to enterprises/entrepreneurs and households). The NBS was instrumental in quickly restoring confidence in the banking system. The run-on the banks in October 2008 had limited effects and most deposits withdrawn mainly by households have been recovered during 2009. Having stabilised the exchange rate through a tightening of the monetary policy, the NBS reversed course during 2009 and provided appropriate liquidity, notably through the lowering of the reference rate and administrative and regulatory measures. Credit activity to households and enterprises was sustained also owing to the European Bank Coordination ("Vienna") Initiative where foreign parent banks committed to maintain their exposure at the 2008 level.

In response to mounting problems under tighter external financing conditions, Serbia requested assistance from the IMF. The initial precautionary Stand-By Arrangement for EUR 420 million over 15 months was revised following a further deterioration of the economic situation in the first half of 2009, and almost EUR 3 billion were made available for the period 2009–2010. The conclusions of the third review in February 2010 were positive as the performance criteria were all met by end-December and the third tranche of the loan of EUR 360 million was made available for release in May. The authorities decided to draw only half of the planned instalment, which brings total disbursements under the current programme at about EUR 1.3 billion. In view of the fragile economic situation and outlook the WB has approved a package of Development Policy Instruments. The EU is providing budget support of EUR 100 million under the Instrument for Pre-Accession and macro-financial assistance of EUR 200 million conditioned on the satisfactory fulfilment of the economic policy conditions.

In line with the IMF conditions, the government implemented a number of fiscal expenditure measures capping current expenditures through a nominal freeze of public sector wages and pensions as well as restricting hiring in the public sector in 2009. In addition, there was across-the-board trimming of discretionary expenditure. As the economic recovery is slow to materialise, the government pledged to continue to support lending to the real sector through banks' loans at discounted rates in the amount of EUR 1.3 billion which should provide ample liquidity for initiating investment or SMEs projects. It has indicated that these subsidies will be directed towards dinar credits (instead of lending in foreign currency) which would be a step towards de-euroisation of the economy. The NBS has also announced a simplification of the reserve requirement regime as well as the lowering of the obligatory reserve rate for new loans and savings with the commercial banks from April 2010, for dinars from the current 10% to 5% and foreign currencies gradually from 40-45% to 25%. The programme provides the fiscal cost of the measures taken so far to alleviate the effects of the crisis.

4.3.2. Medium-term macroeconomic scenario

The macroeconomic scenario has been revised substantially from the previous programme and reflects more appropriately the latest economic developments. The underlying assumptions on the international environment based on the IMF projections from October 2009 are largely realistic. Furthermore, the framework is sufficiently comprehensive and consistent although it would have benefited from alternative scenarios. Nevertheless, there is much scope for improvement in the supporting analysis of the forecasts, in particular for the labour market, to allow an in-sight into the projected developments of macroeconomic aggregates as well as to better explain links and causalities between them.

The medium term macro economic scenario is broadly plausible. As the global economy recovers, the economic activity is to pick up from 2010 leading to growth rates of 3% in 2011 and 5% in 2012, mainly driven by domestic demand. However, downside risks are far from negligible and an analysis of risks to this scenario is not elaborated.

Real sector

The macroeconomic scenario underlying the programme anticipates the economy to recover from 2010 although there are uncertainties as to the timing and strength of the revival. In 2010, real GDP is expected to increase by 1.5% as domestic demand, in particular investment, picks up and is further strengthened by modest export expansion. The programme assumes real GDP growth to accelerate, doubling to 3% in 2011 (a downward revision from an earlier 4.5% forecast) following the strong recovery of investment expected to reach its pre crisis level in 2012. Growth would further increase to 5% by 2012. As imports are likely to rise in step with the vigorous investment activity and the gradually strengthening private consumption, the positive contribution of net exports to GDP growth from 2009 is projected to turn negative again in 2010 and continue deteriorating until 2012. Throughout the programme period, cyclical conditions (as measured by the output gap) should improve steadily.

On the supply side, economic activity is expected to be driven by a strengthening industrial production while the services sectors – the major impetus to growth in recent years are expected to hardly contribute in 2010 but are set to gradually become one of the driving forces of the value added growth again after 2011. The favourable developments in the real economy are reflected in the expected moderate increase of employment as of 2011 (0.5% and 1.1%, respectively) while the wages are set to rise with productivity growth.

Overall, the programme's growth forecasts correspond to the Commission services' internal projections of the macroeconomic developments with a slightly upbeat view on the real GDP growth rates. The growth path underlying the macroeconomic scenario (see Table 5.1) can thus be regarded as plausible. It is, however, noteworthy that the structure of growth does not reflect a shift in the economic model from predominantly domestic-based to more exports-driven growth, which the government has recently underscored as key in the future macroeconomic framework.

Inflation

In the context of its inflation targeting policy, the NBS has set a target band for the CPI inflation rate at 6% +/- 2% in 2010. Inflation is expected to move around the lower limit of the band in the first half of 2010 already taking into account the expected rise of administered prices following a hike in energy, gas and telecom fees in the first quarter of the year. The disinflationary trend is expected to continue against the background of stable monetary developments as well as contained household spending, with inflation expected to fall to 4.5% +/- 1.5% next year and further to 4% by 2012. Although the pass-through of the exchange rate depreciation on price developments has been considered as limited it will remain to be tested in the following years depending on the monetary policy setting.

Monetary and exchange rate policy

The National Bank of Serbia has price stability as its main objective and since 2009 pursues inflationary targeting by setting a broad band around the targeted CPI inflation rate (instead of core

inflation, as previously)([24]). The main monetary policy instrument in achieving the target has been the two-week repo interest rate. The NBS has cut the benchmark interest rate successively by 825bps to 9.5% by the end of December 2009.([25]) The NBS has announced that in the future rate cuts would be more gradual and exchange rate developments would be taken into consideration. As the financial crisis kicked in late 2008, the NBS has strengthened its interventions in defence of the inflation target when exchange rate developments jeopardized its achievement. When the exchange rate depreciation loomed following the 2008 crisis of confidence (see Box 1) and faced with potential risks to financial stability in the environment characterised by high euroisation the NBS's interventions have been largely motivated to buffer the depreciation pressures. Although the NBS has vowed to limit foreign exchange market operations to avoid extreme exchange rate volatility it has repeatedly intervened in the interbank market during the crisis to boost up liquidity and dampen depreciation of the dinar([26]). In effect, a smoothening of the exchange rate depreciation has become a subordinate monetary target subject to achieving the inflation target.

The monetary policy framework for inflation targeting is difficult to implement given the high euroisation of Serbia's economy. Also, the credibility of the central bank is consistently tested with its interventions on the foreign exchange market. In 2010, it has continued its policy of selling currency reserves on the foreign exchange market.([27]) This year, the exchange rate policy is subordinate to keeping inflation within the broad inflation target of 6%. However, the depreciation trend is expected to continue should the demand for euros keep up the recent upward trend and insofar the capital inflow and foreign direct investment recovers to pre-crisis levels (EUR 1.3 billion in 2009, down from 4 billion in 2006). Although the nominal depreciation has been significant real exchange rate developments, on the other hand, do not point to considerable misalignment; in REER terms, the dinar is about 20% stronger than in 2004. In a number of actions aimed at preserving the monetary stance, the NBS has from April 2010 instituted the use of swap transactions of foreign currencies as a regular instrument of monetary policy. This will enable the sale and purchase of foreign currencies against dinars between the NBS and commercial banks for a term of three months, thereby boosting transactions on the inter-bank foreign currency market. Finally, the inflation targeting policy will hinge on the unfinished price liberalisation process.

External sector

Against the background of a gradual economic improvement, the current account is forecast to widen substantially over the period 2010-1012 but stay well below the 2008 level of 17.1%. By 2012, the current account is to reach -12.6%. The programme assumes that the deficit would be fully covered by an expected inflow of FDI worth around EUR 1.8 billion per annum on average, thus reaching its pre-crisis level in 2012, as well as foreign loans. Consequently, Serbia’s foreign debt is projected to increase by about EUR 5.6 billion but in terms of GDP will remain at the level of 73%. As foreign exchange reserves recovered fully during 2009 to reach EUR 10.6 billion, also thanks to the IMF front-loaded programme disbursements, they are expected to remain at a level sufficient to cover eight-months worth of imports of goods and services.

While recent developments such as the revised Vienna Initiative and the implementation of the Interim Agreement (see also Section 4) confirm that capital from abroad would remain available over the medium-term, a number of uncertainties surround the current account developments. On the one hand, the current account deficit could widen markedly due to rallying imports following a boom in domestic demand and/or a world-wide increase in commodities prices as the economic circumstances

([24]) The inflation targeting regime has been instituted by the *Memorandum of the National bank of Serbia on Inflation Targeting as the Monetary Strategy*, effective from 1 January 2009. In effect however, the NBS has been committed to inflation targeting since 2006.

([25]) The interest rate stands at 8.5% after being slashed twice by 50bps since the beginning of the year.

([26]) In the period 2008-2009, the dinar depreciated against the euro by 25% in nominal terms.

([27]) By April 16, the cut-off date for the assessment, the NBS has sold a total of EUR 636.5 million.

improve. Furthermore, the assumption of considerable current transfers, including remittances, could prove rather optimistic. On the other hand, scarce financing might limit the imbalances on the current account. While the remaining privatisation of several state-owned enterprises, such as the telecommunication operator Telekom and the incumbent Electrical Power Company, provides opportunity for significant capital inflows, a return to past levels of FDI inflows might not materialise in the current environment. In a domestic environment characterised, according to the programme, by gradual disinflation, credit growth may accelerate on the back of falling interest rates, thereby exerting pressure on the private savings-investment balance. The planned reduction in general government net borrowing will be insufficient to offset a broader gap in the private sector savings-investment balance. In this context, developments in domestic credit growth, foreign debt dynamics and associated macroeconomic and financial stability issues would become important considerations in discussing the public finances situation.

Main risks to the macroeconomic scenario

The programme briefly mentions risks to the macroeconomic scenario but fails to provide potential impacts of various risk factors on the macroeconomic aggregates. The risks are largely related to the developments in the international environment given the uncertainties regarding the global economic revival. Moreover, the growth assumptions might prove overly optimistic should domestic demand fail to provide the anticipated impetus to growth in case that lower-than-expected FDI inflow would squeeze the financing of big investment projects and/or remittances would no longer sustain private consumption. In fact, an adverse spill-over from the Greek crisis could materialise mainly through FDI([28]) but is expected to be limited as a substantial decline in Greek FDI flows has already occurred since 2008.

On the downside, a potential hike of commodity prices in the international markets would build-up inflationary pressures. Exchange rate volatility might also exert inflationary pressures and adversely affect the export-oriented private sector as well as have adverse wealth effects([29]).

However, some of the major downside risks are predominantly domestic. The macroeconomic framework is contingent on the pursuit of the policy reform programme committed to by authorities and supported by the IMF SBA arrangement. Certainly, the medium-term outlook hinges on the country's political will to implement measures which are considered as key for maintaining economic stability. Fiscal policy is a key area where uncertainties prevail. For instance, the programme only sets broad policy guidelines for the wages in the public sector and the extension of the restrictive wage agreement to the period beyond the first half of 2010 has not yet been confirmed. A number of structural reforms (pension, education, health) will also have to be implemented with a view to reducing current expenditures. A potentially adverse effect for domestic debt, on the other hand, is related to the cost of a restitution of property rights in the outstanding de-nationalisation process.

4.4. PUBLIC FINANCE

The medium-term fiscal strategy is geared to reducing the general government deficit from 4.2% in 2009 to 2.4% of GDP in 2012 by downsizing and restructuring the general government expenditure. Compared with the previous programme, the new strategy proposes considerably less ambitious fiscal targets against a significantly more unfavourable macroeconomic scenario. The consolidation is expenditure-based, to be materialised through decreasing the share of general government expenditure by 2.2% of GDP by 2012. To that end, the programme announces the extension of the current

([28]) The stock of FDI to Serbia is 15% Greek-owned and accounts for 7% of GDP.
([29]) As the purchasing power decreases the weakening exchange rate weighs heavily on the household indebtedness since the majority of debt is euro nominated.

expenditure measures while capital expenditure is planned to increase by 0.4% of GDP. Over the programme period, the general government revenue ratio is expected to fall by 0.4 percentage points to 38.3% of GDP. Public debt is expected to rise but remain contained at below 35% of GDP.

The medium-term public finance framework is coherent as it broadly corresponds to the underlying macroeconomic assumptions and reflects the overall policy objectives. It may, however, prove rather optimistic based on the budgetary performance in the first months of 2010 which could result in a substantial revenue slippage. In these circumstances, the reduction of the expenditure ratio by holding a firm grip on the current expenditure is appropriate albeit rather modest. Nevertheless, the government should see that expenditure cuts by downsizing public administration by 10% do not undermine its administrative capacity in the priority areas of the EU integration process.

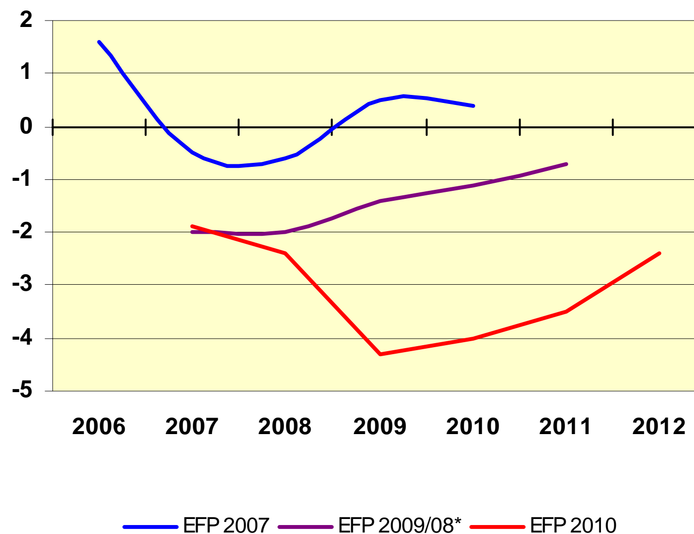
Preserving capital expenditures, on the other hand, will allow Serbia to keep up to the objective of enhancing the growth potential of the economy. In this regard, however, the fiscal consolidation could be more ambitious by advancing structural reforms, in particular the enterprise sector restructuring and privatisation. The programme recognises the key role of timely reforms in the public domain, including of reform of the pension and health systems, but does not specify the details of the most important fiscal measures nor does it provide any quantitative assessment of their impact on the economy and budget. Likewise, quantification is missing in the discussion of fiscal risks and in the brief analysis of the exchange rate- and GDP growth-sensitivities of public debt.

4.4.1. Budget implementation in 2009

In 2009, the general government deficit is estimated to have reached 4.2% of GDP. In the face of the crisis, the initial assumptions for 2009 have proven overly optimistic with the faltering revenue performance and the originally planned fiscal deficit of 1.8% was out of reach. The fiscal position continued to deteriorate rapidly until the government implemented measures agreed with the IMF during the first review of the SBA in March when the deficit target was raised to 3% of GDP. These were primarily designed to cap the current expenditures and put the public finances back on track. Still, the fiscal deficit target set for the first half of the year was missed as the economic situation was worse than expected in the spring. During the second review of the IMF programme the fiscal deficit target was revised down for a second time, to 4.5% of GDP. The budgetary performance having recovered somewhat toward the end of the year, the preliminary outcome for 2009 is slightly below the anticipated deficit.

Compared to 2008, the expenditure ratio is estimated to have declined by 0.5 percentage points to 43% owing to substantial savings in the current expenditures (which account for more than 90% of total expenditures and almost 40% of GDP). The fiscal adjustment came largely from the restricted hiring in the public sector and a nominal freeze of public sector wages and pensions. These fostered substantial savings on the public sector wages while the growth of pension outlays has been contained([30]) (both items account for two thirds of total spending and almost a quarter of GDP) but social assistance spending was preserved. Furthermore, capital expenditures (accounting for almost 7.5% of total spending and 3.2% of GDP) were further strained having declined by 11% y-on-y, twice as much as a year earlier. 2009 also saw a drop in the share of revenues as a percentage of GDP, estimated at 2.4 percentage points compared to 2008, to 38.7% of GDP. A generally poor economic situation involving extensive lay-offs in the private sector and salary freezes in the public sector translated into a shortfall in personal income tax revenue. Furthermore, indirect taxation (customs revenues and VAT) plunged following the drop in domestic demand and imports. Conversely, excise taxes increased as a consequence of the rise in excise duties on diesel and gasoline.

([30]) A pension hike at the end of 2008 has resulted in an increase of the share of pension expenditures in the GDP from 12% in 2008 to 13.4% in 2009.



* As from 2009 the Economic and Fiscal Program is presented end-January, instead of December (2008)

4.4.2. Medium-term budgetary strategy

In December 2009, the parliament adopted the supplementary budget for 2009 together with the budget bill for 2010. The 2010 budget targets a general government deficit of 4.0% of GDP, envisaging a further drop in the general government revenue by 0.4 percentage points, to 38.3% of GDP and an even more substantial reduction of the general government expenditure by 0.7 percentage points, to 42.3% of GDP. The programme, however, does not systematically present the details of the fiscal measures and their effect for the 2010 budget.

The main policy goal in the medium-term remains to proceed with a steady fiscal consolidation and make public finances sound over the programme horizon. In the programme, the consolidation path is kept gradual and its time profile remains back-loaded while the pace of adjustment has been slowed somewhat against a significantly worse macroeconomic scenario compared with the previous programme. Overall, expenditure projections seem plausible but revenue projections may turn out rather optimistic, considering a standstill in enhancing revenue collection. Indeed, as from the beginning of 2010 budgetary developments have faltered due to a weaker revenue performance than expected. According to the programme, the general government deficit is expected to slowly decrease, to 3.5% in 2011 and further to 2.4% of GDP in 2012.([31]) The deficit is expected to be financed through issuing dinar-denominated treasury bills and domestic borrowing with commercial banks on the one hand and external borrowing from International Financial Institutions, on the other hand. Privatisation proceeds have been envisaged to cover the fiscal financing gap only to a limited extent (EUR 30 million in 2010 linked to the possible sale of a major pharmaceutical company) as the privatisation process has stalled given the lingering uncertainty about the global economic recovery.

Since 2006, the public finances have been continuously eroded by weak fiscal discipline and expansionary policies. Thus, fiscal policy is predicated on improved quality of public finances based

([31]) The medium-term budget targets are in line with an IMF SBA agreement.

on, *inter alia*, reducing general government expenditure. Adjustment in the medium-term is expenditure-driven, but the programme does not specify in sufficient detail the measures taken so as to curb public spending. The programme announces the extension of the savings measures on the current expenditures mainly by restraining payroll, social benefits and transfers as well as public consumption, leading to a drop in the share of expenditures as a percentage of GDP by 2.2 %, to 40.7% of GDP by 2012. The foreseen adjustment is even and smooth over the entire programme period. Between 2009–2012 current expenditure is expected to decline by 2.7% of GDP mainly on the back of a gradual fall of the wage bill as the government committed to a 10% cut in public administration employment while the authorities have indicated that the nominal freeze is to be lifted provided that economic conditions allow for it. Furthermore, it is unclear how the pension bill will remain contained since the semi-annual indexation is to be reinstated as of March 2011. On the other hand, the capital expenditure is projected to strengthen again by 0.4% by the end of the programme period to fund national infrastructure projects, such as the Corridor 10 road and railways line.

On the revenue side, the programme projects a drop in the share of revenue as a percentage of GDP by 0.4 percentage points by 2012 whereby the reduction mainly occurs between 2009 and 2010; afterwards the revenues remain rather stable. The reduction of the revenue ratio is projected as a consequence of the lower personal income since the labour market is expected to remain very tight following the planned lay-offs and the extension of the nominal freeze of wages in the public sector into 2010. After 2011, the income tax revenue is expected to stabilise as employment grows steadily. Value added tax is set to be stable at just below 10.5% of GDP over the programme horizon. Custom duties, however, are projected to also decline marginally in 2011 in step with the implementation of the SAA agreement.

Table II.4.2:

Composition of the budgetary adjustment (% of GDP)

	2009	2010	2011	2012	Change: 2009-12
Revenues	38.7	38.3	38.1	38.3	-0.4
- Taxes and social security contributions	35.8	35.1	35.2	35.2	-0.6
- Other (residual)	2.9	3.2	2.9	3.1	0.2
Expenditure	43.0	42.3	41.6	40.7	-2.2
- Primary expenditure	41.5	41.2	40.5	40.0	-1.5
of which:					
Gross fixed capital formation	3.2	3.5	3.5	3.6	0.4
Consumption	17.4	16.8	16.3	16.1	-1.3
Transfers & subsidies	20.9	20.7	20.3	19.5	-1.4
Other (residual)	0.7	0.1	0.0	0.0	-0.7
- Interest payments	0.8	1.2	1.5	1.5	0.7
Budget balance	-4.2	-4.0	-3.5	-2.4	1.8
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-3.5	-2.8	-2.0	-1.0	2.5
Gross debt level	31.3	34.0	34.8	34.3	3.0

Any provisions for fiscal risks, including contingent liabilities, in the fiscal framework are not clear from the programme. The programme would have also benefited from presenting alternative fiscal scenarios or a sensitivity analysis to main variables, including growth. Nevertheless, the public finance plan for the medium-term clearly reveals the need for considerable fiscal restructuring. As financing of an extensive public investment agenda is strained by dwindling revenues and increasing debt-servicing cost in the next few years it will be paramount to carry out an overhaul of public spending. The proposed fiscal consolidation is contingent on slashing substantially current expenditure. To that end, the government has initiated a rationalisation in the public administration. Furthermore, it has identified a number of necessary adjustments to the pension and health systems,

which will need to be designed in a way to alleviate increasing age-related expenditures in the future. The lack of firm commitments of the authorities regarding, in particular, the announced reforms (nor specific timetable nor budgetary impact), however, leaves targets exposed to implementation risk. Furthermore, the absence of clear schedules for the reduction of government spending, especially in light of the recent discussions to re-introduce indexation of pensions to wages, may make the realisation of the targets difficult. In particular, the high share of mandatory expenditure (more than 90% of the overall outlays) is rooted in the rigid regulatory framework, which awaits political consensus to be restructured in a more flexible way. Tangible signs of economic recovery will not be felt before 2011 so any precipitated action towards the relaxation of the measures would undermine the consolidation path.

Budgetary implications of "major structural reforms"

The programme does not provide the requested matrix on policy commitments and therefore does not include quantitative information on the budgetary impact of major structural reforms. However, the net-effect of major structural reforms will have a significant impact on the country's fiscal position. Overall, the measures address important structural weaknesses and therefore are likely to contribute to Serbia's growth potential.

4.4.3. General government debt

Compared to the previous programme, when gross government debt was estimated to decline to 26.9% of GDP by the end of 2009, the updated programme estimates the debt ratio to have reached 31.3% of GDP, up from 25.6% in 2008. Over the programme horizon, the debt ratio is set to remain relatively low, although the government anticipates a rise in 2010 and 2011. Gross government debt is expected to peak at 34.8% of GDP in 2011 before retracting again in 2012 to 34.3%. Given the projected fiscal deficits over the programme horizon and assuming an only gradual pick-up of GDP growth such a development is realistic. Borrowing for large-scale infrastructure projects([32]), substantial financing provided by the international finance institutions and a possible continuing depreciation of the exchange rate should result in a higher degree of indebtedness.

The updated programme remains silent on the government's intentions concerning the sale of state-owned equity and the subsequent use of revenues to reduce public debt. The effect of privatisation proceeds on the level of debt can therefore not be inferred. As privatisation proceeds during previous years have been to a large extent used, the authorities have started issuing domestic treasury bills to finance part of the fiscal deficit during the programme horizon. Introduction of treasury bills and bonds of longer maturity and the development of corporate and municipal bond markets will support the dinar and at the same time mitigate the exchange rate volatility. The programme provides a basic analysis of the sensitivity of public debt to changes in the exchange rate, GDP growth and tax revenues. The risk of negative shocks to the debt can be considered as limited.

Nevertheless, the debt portfolio is deemed vulnerable as the currency structure shows predominantly euro-denominated external debt([33]) while a long-term repayment profile spreads evenly over time. At the end of 2009, approximately two-thirds of the public debt was foreign. For the medium-term, the government expects that interest expenditure will increase from 1.2% of GDP in 2009 to 1.5% of GDP by 2012. It has, however, planned to enforce a more active policy of debt management with the aim to reduce the cost of borrowing in the future.

([32]) Although the macro-fiscal framework assumes vigorous investment activity to be largely supported by public means, the programme remains silent on the details of financing needs as well as borrowing plans.
([33]) At end-January 2010, 66.4% of Serbian public debt is denominated in euro, 13.3% in US dollar, 12.5% in Serbian dinar, 4.8% in special drawing rights (SDR) and 3% in other currencies (source: Bulletin of Public Finance, Feb 2010).

4.4.4. Quality of public finances and institutional features

While the reduction of current expenditure foreseen in the programme is not very ambitious, the plan to increase public investment is largely appropriate. Reforms of the pension and health systems are vital in containing the cost of population ageing in the future. The reform in education is also considered necessary in order not to yield savings – indeed, the cost might well increase somewhat – but to improve outcomes. The implementation of such fiscal adjustment will prove very challenging in the face of squeezed revenues. To enhance careful budgetary planning the programme foresees measures to improve transparency of public finance, to instil fiscal responsibility and to strengthen budget and debt management. Adoption of the indicated additional amendments to the new Budget System Law would lead to a budgetary process that better embraces the Medium-Term Expenditure Framework (MTEF). The new macro-fiscal setting which will include the three-year expenditure ceilings is to be for the first time established in 2010 in the new Budget Memorandum for the year 2011 with projections for 2012–2013. The inclusion of a mid-term investment plan with clearly defined project priorities is also foreseen in the forthcoming budget memorandum due to be adopted by June this year. Further on, the fiscal consolidation strategy will need to concentrate primarily on the composition and efficiency of public expenditure as well as revenue mobilization. On the side of expenditures, a fine balance is needed between restructuring towards productive public spending and keeping the appropriate social net to safeguard macroeconomic stability. As of 2010, the legal framework is expected to be adapted to allow the government to safeguard the deficit target in case economic conditions impinge on the public finances.([34]) While the programme mentions the introduction of quantitative rules in the budgetary process no details to this end are provided. For instance, Serbia might benefit from an effective mechanism of containing general government expenditures/keeping budgetary performance on track in response to a revenue shortfall.

A comprehensive legislative framework for sound public finance management is already in place. The development of a forward looking budgetary planning process is well advanced and efforts to introduce a multi-annual budgetary horizon are acknowledged.([35]) Furthermore, fiscal accountability has recently been tested for the first time. The State Audit Institution, an independent external audit body, finalised its first report on the financial statements for the 2008 State Budget.([36]) Also, to strengthen and modernise budget management a Public Debt Administration has been established.

Follow up activities will be necessary in further strengthening and completing a number of Public Finance Management (PFM) reforms to make public finances transparent, reliable and efficient. For instance, some elements of the existing legislation still need to be fully implemented, in particular regarding the roll-out of the financial management information and accounting system throughout the public sector as well as the consistent of the budget preparation based on the MTEF. Also, the strengthening of administration capacity in tax collection will allow additional resources to be channelled toward growth-enhancing public investment.

Serbia appears to be at high risk as to future budgetary costs on grounds of population ageing. The nominal freezing of pensions in 2009 was an important step which helped contain pension outlays after a substantial increase at the end of 2008. Nevertheless, the medium-term effects remain largely unclear given the uncertainty related to the future indexation rule, i.e. adjusting pensions to inflation in keeping with the best international practice, as opposed to wages in the public sector, which seems to be the preferred options of the authorities. Furthermore, if no other parametric changes in the pension and health schemes are taken to relieve the pressures of age-related expenditure the long-term

([34]) The amendments to the new Budget System Law with provisions in the field of fiscal responsibility are to be adopted by May 2010.
([35]) The activities are carried out in the framework of introducing programme-budgeting.
([36]) The report proposes the opening of misdemeanour proceedings for the misappropriation of funds is a positive development for establishing fiscal transparency and is expected to be followed on by the legislature and in judiciary.

sustainability of public finances will be undermined. A careful planning of measures is key in this regard.

4.5. STRUCTURAL REFORMS

Despite the expected recovery Serbia will witness difficulties related to structural rigidities which limit the country's potential output and investment. In particular, high unemployment and a growing number of insolvencies([37]) weigh on the economic performance. The policy priority is to advance structural reforms in the direction of developing industrial sectors at the high value-added part of the productive chain which will bolster export expansion. The projected economic performance will further depend on the country's ability to attract foreign investment.

To that end, the programme presents a comprehensive structural reform framework, covering a wide range of structural policies related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. The structural reform strategy addresses the fulfilment of the Copenhagen economic criteria. The agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. The structural reform plan, however, is not reflected in the fiscal strategy in a straight-forward manner. The programme does not present clear timetables for implementation of the most important structural reform measures nor does it systematically list the estimated fiscal impact.

4.5.1. Product and capital markets

The privatisation of public enterprises is the weakest point of the reforms in Serbia. Since 2001, restructuring and privatisation of *socially-owned* enterprises has advanced relatively well but was stalled due to unfavourable market conditions during the recent crisis. While calls to review past privatisation cases have resurfaced on grounds of money laundering allegations, the official stance is that the process would be completed by the end of 2010, one year behind the deadline. As the economy recovers, the privatisation process should advance for the remaining companies which are in the process of restructuring or in the process of bankruptcy and/or forced liquidation, or for companies whose privatisation has been cancelled. The authorities will urgently need to devise an efficient strategy towards the firms where the sale contracts have been repealed in cases where authorities concluded that the buyer was in breach of some or all of the five standard requirements of the sales agreement. Another priority over the programme horizon remains liberalisation of the *state-owned* infrastructure activities such as the electricity, telecom, airport and pharmaceutical companies.([38]) The government still has to define restructuring and privatisation strategies for most of the enterprises concerned. To facilitate the privatisation of the remaining state-owned enterprises, the government intends to distribute free shares of these companies worth 15% of their equity to the population, which has not benefited from any share distribution in the past. However, the programme remains silent on the plans to sell the remainder of their assets in 2010. The postponing of the privatisation process might restrain the fiscal space to support the planned fiscal consolidation should revenue fall short of projections.

While great strides have been made in transforming the economy, important challenges remain especially related to creating a business-friendly environment. Going forward, it is key to establish legal predictability, remove excessive administrative requirements and barriers to doing business. A

([37]) Although the new law adopted in December 2009 was a welcome step towards speeding-up bankruptcy procedures, the efficiency of courts in dealing with these procedures remains an issue of concern.

([38]) Until the preparation of the assessment only a tender for one of the pharmaceutical companies has been in the advanced stage.

number of international development financial institutions also have special loan arrangements in support of infrastructure investment or development of SMEs.

A comprehensive reform of the legislative and regulatory framework is being implemented for the financial sector. To further develop the Serbian capital market steps, such as the enhanced capacity of the supervisory body Securities Commission, are considered as necessary to help diversify the financial system and contribute to greater stability. While reform of the banking system is ongoing, transition from a compliance-oriented regime to a risk-based supervision is likely to be gradual. The programme anticipates that this year would see an end to the delay in privatisation of the remaining three state-owned banks. For the insurance sector, the regulatory framework is planned to be further developed and the sector's supervision strengthened.

4.5.2. Labour market

Important structural challenges remain on the Serbian labour market, reflected in the persistently high unemployment, a low participation rate, particularly of older workers. Structural rigidities in the labour market impede catching-up. Furthermore, real average wages increase above labour productivity gains, although the gap has substantially narrowed in recent years. In 2010, the key labour market measure will be downsizing of public administration employment by 10%, as per the agreement with the IMF. According to the programme's labour market strategy, employment is to rise as a result of investment in human resources and completion of privatisation. A new employment law is planned to enhance institutional capacity for job creation, improve labour market flexibility and to facilitate partnerships between employers, job-seekers and labour market institutions. The programme, however, does not envisage any measures aiming at the reduction of social security contributions, which remain comparatively high in Serbia and are an impediment for increasing the employment rate.

4.5.3. Other reform areas

The programme covers several other reform areas with implementation backlogs but little progress is expected in any of them given the absence of clear action plans. The single biggest challenge remains steeping up the processes of denationalisation and restitution. Another key reform in the public sector is pay grade reform which should allow for a more transparent system by reducing and streamlining the number of grades as well as to clearly defining salary parameters. Also, the government would need to implement reforms in the health and education sectors which have been identified with the help of the World Bank. Moreover, further reform of the social welfare system is envisaged, aiming at providing a better targeting of social transfers and improved protection for the most vulnerable groups. The reform programme attempts to strengthen social inclusion through capacity building and decentralisation of institutions which provide social welfare services.

4.6. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Overall, the programme is a reasonable document, which has been co-ordinated by the Ministry of Finance between the relevant stakeholders in the design and implementation of macro-fiscal policies. For it to serve as a key national strategic document over the medium term the authorities might find it useful to ensure partnership and enhance co-ordination in the preparation stage. There is much scope for improvement in producing a more concise, structured and well-balanced document that would embrace ownership with all economic policy stakeholders as well as raise its profile as a medium-term economic policy strategy paper with the public domestically and abroad.

As regards the macroeconomic framework, the programme gives a clear and concise picture of past economic developments and covers all relevant data available at the time of submission.

As regards the fiscal framework, the programme adheres to the model structure specified in the EFP guidelines. The data requirements have been met, with minor gaps in providing up-to-date information.([39]) Fiscal data are presented according to the IMF General Financial Statistics (GFS) methodology. The public accounting - although not yet formally aligned with the international standards - can be considered as largely appropriate. The timing of submission of the programme limits the occasion to align it with the budget cycle within the current legal setting. A plan to implement proper medium-term budgetary planning with a three-year fiscal framework based on the Medium Term Expenditure Framework should allow a more informed and analytical in-sight into the expected fiscal developments. In particular, this should include a comprehensive overview of the adopted/planned revenue and expenditure measures for each of the annual budget bills together with their expected fiscal effects.

As regards the structural reforms framework, the presented information is coherent and sufficiently comprehensive. It confirms the policy priorities but does not provide detailed roadmaps for reform over the medium-tem. It announces pension and health reform focused on expenditure capping but does not specify the features of the future system. The absence of cost/benefit analyses and implementation schedules hinders the evaluation of the fiscal sustainability of the structural reforms.

([39]) Public debt data was only provided until 2008.