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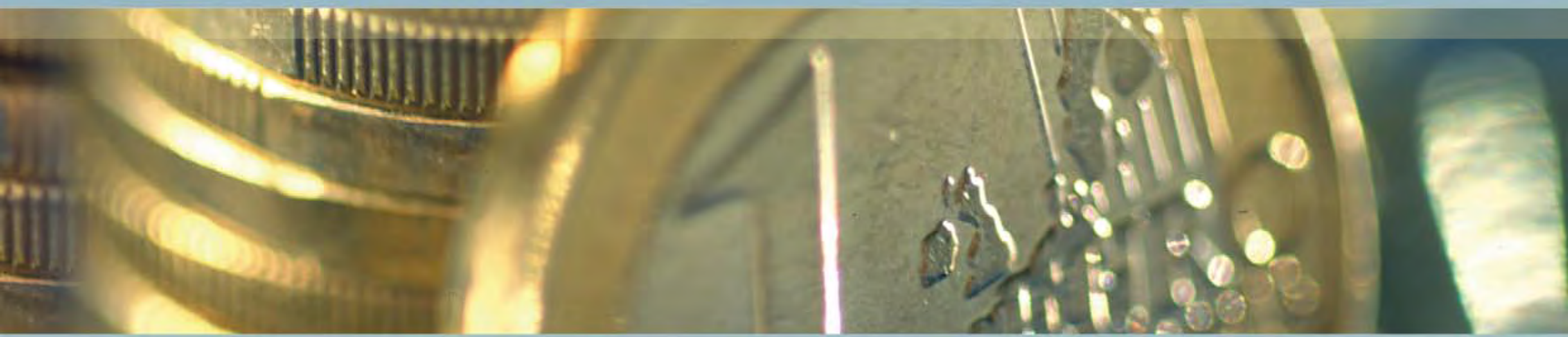

2010 Pre-accession Economic Programmes of candidate countries: EU Commission assessments

Directorate-General for Economic and Financial Affairs

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2010 Pre-Accession Economic programmes of candidate countries: EU Commission's assessments

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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 Pre-accession Economic Programmes of the candidate countries (Croatia, the former Yugoslav Republic of Macedonia and Turkey) covering the period 2010-2012.

The Pre-Accession Fiscal Surveillance Procedure was established in 2001 and aims at preparing candidate 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) that candidate countries submit annually are part of this procedure.

The PEPs have two objectives. First, to outline the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. Second, they offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with 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 in each country of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

The three countries have published their 2010 programmes, which can be found on the web under following addresses:

Croatia	http://www.mfin.hr/adminmax/docs/2009_Pre-accession_Economic_Programme.pdf
The former Yugoslav Republic of Macedonia	http://www.finance.gov.mk/files/u9/PEP_2010_2012_Macedonia_new.pdf
Turkey	http://www.dpt.gov.tr/DocObjects/View/7798/PEP2009.pdf

These assessments were prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Christophe Pavret de la Rochefordière and Carole Garnier. The principal authors were Uwe Stamm (Croatia), Bernhard Böhm (the former Yugoslav Republic of Macedonia) and Dirk Verbeken (Turkey).

The programmes and this assessment were discussed at experts' level in two multilateral meetings held in Brussels on 28 April and 4-5 May 2010 and at ministerial level during the ECOFIN Council on 18 May. Representatives from EU Member States, the ECB, the Commission and the candidate countries attended this meeting.

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Part I

Overview

1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Croatia, the former Yugoslav Republic of Macedonia and Turkey were invited to submit by 31 January 2010 their annual *Pre-accession Economic Programmes* (PEPs) covering the period 2010-2012. The preparation, assessment and discussion of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for their eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union (EMU).

The submitted programmes contain overviews of economic policy plans over a broad range of issues during the programme period. In particular they show the governments' intentions to advance structural reforms, productivity gains and alignment with the EU *acquis* and EU best practices that will allow sufficiently high growth in order to catch up with, and prepare for membership in the European Union. However, the degree of ambition and precision in policy implementation across the programmes is not uniform.

This exercise of submitting, assessing and discussing annual PEPs will continue to support the countries in their preparation for accession. The EU provides an important anchor in this effort. A further integration of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy formulation, in particular the economic chapters of the Progress Reports and Accession Partnerships and the bilateral economic dialogues with the countries, can increase the EU's effectiveness in this respect. Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2. BACKGROUND

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

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

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

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

1.2.1. The 2010 Programmes

Countries were requested to submit their programmes by 31 January 2010. Croatia complied with this deadline, while Turkey and the former Yugoslav Republic of Macedonia submitted their programmes with a delay. All three programmes have been made public. ([1])

The main elements of the assessment are the following:

- The economic frameworks of the three countries present a rather differentiated impact of the global financial crisis on their economies. Croatia and Turkey expect a rather strong impact in 2009, with a decline in real GDP by about 6%, while the former Yugoslav Republic of Macedonia is more optimistic, envisaging a growth decline by 0.6% only. With respect to the post-crisis recovery, Turkey and the former Yugoslav Republic of Macedonia are more optimistic, expecting 3.5% and 2% growth in 2010, which is expected to accelerate to 5% by 2012. The Croatian framework is more cautious, forecasting output growth of 0.5% in 2010 and envisaging an acceleration of growth to 3.5% by 2012. All three programmes envisage the recovery to be driven mainly by domestic demand, based on expected improvements in consumer confidence and on recovering investment. This domestically driven growth acceleration translates in all three programmes into a widening of the trade deficits. Overall, the programmes' assumptions still tend to be on the optimistic side. Uncertainties related to the recovery are still high, in particular with respect to the future performance of external demand and capital inflows, notably tourist revenues, workers remittances, FDI and portfolio investment. However, compared to last year's submission, the degree of uncertainty has declined and the programmes tend to be more realistic.

- After the sharp deterioration in 2009, the fiscal frameworks of all three countries foresee a continuous decline in fiscal deficits. The biggest adjustment is envisaged in Turkey, where the 2009 deficit had increased by 5 percentage points of GDP, reaching -6.6% of GDP. The Turkish authorities intend to reduce the deficit by 4 percentage points of GDP, reaching -2.7% of GDP by 2012. In Croatia, the fiscal position deteriorated in 2009 by 2 percentage points of GDP, from -1.4% in 2008 to -3.4%. The Croatian programme plans to reduce the deficit until 2012 by about 1 percentage point, to -2.3% of GDP. In the case of the former Yugoslav Republic of Macedonia, the 2009 deficit rose by 1.8% of GDP, from -1% in 2008 to -2.8%. According to the current PEP, the deficit is set to decline during the programme period by 0.8% percentage points of GDP, reaching -2% of GDP in 2012.

- Like in previous submissions, the structural reform agendas reveal a varying focus and degree of ambition. In general, all three programmes would have benefitted from a closer link between presented reform measures and their actual financing in the fiscal framework. Furthermore, the described reform priorities appear in many cases to diverge from accession related priorities, as described in the Commission's progress reports and the European Partnership documents. In the case of Croatia, the programme would have benefitted in particular by increasing efforts to accelerate enterprise restructuring, to improve education and the functioning of labour markets. In

([1]) Croatia:http://www.mfin.hr/adminmax/docs/2009_Pre-accession_Economic_Programme.pdf
The former Yugoslav Republic of Macedonia:http://www.finance.gov.mk/files/u9/PEP_2010_2012_Macedonia_new.pdf
Turkey: http://www.dpt.gov.tr/DocObjects/View/7798/PEP2009.pdf

the case of the former Yugoslav Republic of Macedonia, the commitment towards accession related structural reforms appears to have declined, with shifting labour market oriented support towards the promotion of the agricultural sector. In the case of Turkey, the programme continues to emphasise measures to increase the efficiency in the private sector and of public administration and to strengthen the functioning of the market economy. Often, however, like in previous submissions, the programmes are very detailed when describing past developments and rather vague when explaining intended reform measures. Furthermore, the links between the structural reforms outlined and the macroeconomic and fiscal frameworks would have benefitted from a more explicit discussion. Overall, the full and determined implementation of those reforms should strengthen the economies of the candidate countries, in particular in view of their increasing EU integration.

Table I.1.1:

Pre-Accession Economic Programmes 2010-12 : Key indicators

	2008	2009	2010	2011	2012
Real GDP growth (% change)					
Croatia	2.4	-5.9	0.5	3.0	3.5
The former Yugoslav Republic of Macedonia	4.8	-0.6	2.0	3.5	5.0
Turkey	0.9	-6.0	3.5	4.0	5.0
Unemployment rate (%, LFS)					
Croatia	8.4	9.9	10.3	9.9	9.1
The former Yugoslav Republic of Macedonia	33.8	32.1	30.8	29.4	27.8
Turkey	11.0	14.5	14.3	14.1	13.3
Current account balance (% of GDP)					
Croatia	-9.2	-5.7	-6.0	-6.3	-6.5
The former Yugoslav Republic of Macedonia	-13.1	-8.0	-9.4	n.a.	n.a.
Turkey	-5.7	-1.8	-2.8	-3.3	-3.9
Inflation (CPI, annual % change)					
Croatia	6.1	2.5	2.7	3.0	3.0
The former Yugoslav Republic of Macedonia	8.3	-0.8	2.0	2.0	2.5
Turkey	10.4	6.3	6.4	5.9	5.3
General government balance (% of GDP)					
Croatia	-1.4	-3.4	-3.3	-3.1	-2.3
The former Yugoslav Republic of Macedonia	-1.0	-2.8	-2.5	-2.5	-2.0
Turkey	-1.6	-6.6	-4.7	-3.5	-2.7
General government gross debt (% of GDP)					
Croatia	29.1	33.5	36.1	37.3	37.4
The former Yugoslav Republic of Macedonia	21.3	24.7	26.5	27.1	27.9
Turkey	39.5	47.3	49.0	48.8	47.8

Source: PEP 2010

1.2.2. Crisis related policy issues

To enhance the countries' resilience to the crisis, improvements in the prioritisation of budget expenditure and revenue measures could play a key role, in particular by better targeting those measures that contribute to the functioning of the market economy and to raising the countries' competitiveness. In case additional counter-cyclical public expenditure is approved, it will need to be financed from savings elsewhere in the budget. Overall, establishing the appropriate policy mix has become significantly more challenging than in previous years, which makes the pursuit of a prudent fiscal policy even more important.

1.2.3. The PEPs and pre-accession strategy

The programmes lay out policy strategies which are to a large degree compatible with and conducive to the economic priorities of the Accession Partnerships and, more widely, to the general objective of meeting the Copenhagen economic criteria for accession, i.e. establishing a functioning market economy and raising competitiveness to a level which would allow the countries to meet competitive pressure within the European Union([2]). In some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful.

Technical assistance to candidate countries in the area of economic policy planning and implementation has proven powerful and should be continued.

1.2.4. Follow-up

The programmes and their assessments by the Commission services were discussed within multilateral policy dialogues between Member States and candidate countries. A special meeting of the Alternates of the Economic and Financial Committee (EFC) with representatives of candidate countries took place on 28 April 2010 and discussed and assessed the individual programmes. On 4-5 May, a High-level meeting between the EFC and representatives of the candidate countries was held and draft conclusions prepared at the Alternates level were endorsed. The Ministerial Meeting between the ECOFIN and their counterparts from the candidate countries took place on 18 May 2010. The conclusions of this year's fiscal surveillance exercise were adopted as Presidency conclusions.

This exercise has been, since its start, an annual one. Therefore, the countries will again be invited to submit a programme in early 2011, covering the period 2011-2013.

([2]) So far, the Commission considers Turkey and Croatia to have achieved the status of a fully functioning market economy, while the former Yugoslav Republic of Macedonia is seen to be well advanced as regards meeting the economic criteria and to have continued to move closer towards becoming a functioning market economy.

Part II

Country analysis

1. CROATIA

1.1. EXECUTIVE SUMMARY

Croatia's sixth Pre-Accession Economic Programme ("PEP 2010-2012") submitted in January 2010 presents an overall comprehensive medium-term macroeconomic and fiscal framework projecting a somewhat optimistic pattern of economic recovery from the current recession. Creating the base for economic recovery and stable growth, preserving macroeconomic stability through continued fiscal consolidation as well as ensuring social fairness are the programme's key objectives. The document largely complies with formal requirements and appears broadly consistent with earlier key policy documents and the 2010 budget plan.

The Croatian economy has been severely affected by the global crisis with a strong decline in output of 5.8% in 2009. The recession has increasingly affected the labour market. Employment levels dropped by 5.6% and the unemployment rate climbed to 16.7% at the end of the year. As a result of shrinking domestic demand, annual inflation has fallen to 1.9% in December 2009, despite increases in VAT and excise taxes. The current account deficit declined from 9.1% in 2008 to 5.2% in 2009, as imports have been falling more strongly than exports. After a temporary fall in the first half of 2009, official foreign currency reserves recovered and stood at EUR 10.4 billion at end-2009, equivalent to around 5.5 months of imports. External indebtedness and short term debt service obligations remain a particular challenge. The stock of external debt continued to increase to close to 100% of GDP at end-2009, as compared to around 86% at end-2008.

The medium-term growth scenario appears somewhat optimistic. In particular, the key underlying determinants for the economic recovery of private consumption and investment in 2010 and the relatively strong growth acceleration in 2011 and 2012 are not fully elaborated. Given risks on the downside, the macroeconomic part of the PEP would benefit from presenting alternative growth scenarios, possibly based on the sensitivity analysis provided in the public finance section. The inflation outlook and external projections of the programme appear broadly reasonable. Risks of stronger-than-expected inflationary pressures over the short-term appear limited, also in the context of the outlined policy mix. The nature of the projected recovery could lead to a stronger-than-expected growth of imports and an earlier and more pronounced widening of the trade gap. Higher external financing costs and debt service payments on a growing external debt could add to the external deficit. The PEP realistically projects net FDI flows to remain moderate, significantly below pre-crisis levels, but does not elaborate on other financing flows.

The objective of continued fiscal consolidation and deficit reduction remains appropriate, but challenging. In view of relatively high spending ratios, tight financing constraints and external vulnerabilities, fiscal policy should play a larger role in supporting a prudent and stability-oriented policy mix. However, the programme's fiscal scenario does not appear to be particularly ambitious. The overall magnitude of fiscal adjustment is limited and back-loaded with only little consolidation foreseen in 2010 and 2011. Moreover, the credibility of the fiscal programme suffers from the lack of information on envisaged supporting fiscal measures and their quantitative effects. Measures outlined in the policy matrix have relatively minor budgetary effects, and risks of delays in policy implementation, in particular with respect to subsidy reduction and streamlining of social transfers, appear significant. Therefore, although fiscal targets are not particularly ambitious, they could still be difficult to achieve. The programme does not provide for sufficient contingency planning in case of major deviations from the programmed fiscal path. Finally, the programme contains little evidence that the structure and composition of spending will change to support a more growth-oriented public finance strategy, which represents a key challenge.

The programme covers a range of structural reform areas, such as the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform measures and initiatives with a strong emphasis on legislative action and EU harmonisation. The programme does not fully and consistently establish a clear link between the core objectives and the instruments and measures. To serve as a useful guidance for the implementation of structural reforms, the programme would benefit from the definition of clear policy targets, specific measures and concrete time frames for implementation. More emphasis should have been given to measures to improve the business environment, given the pertaining administrative obstacles still in place. The programme contains fiscal estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy is generally weak and could be further strengthened. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term.

Table II.1.1:
Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP growth (% change)	COM	2.4	-5.8	0.2	2.2	n.a.
	PEP 2010	**2.4**	**-5.9**	**0.5**	**3.0**	**3.5**
Consumer price inflation (%)	COM	6.1	2.6	3.0	3.0	n.a.
	PEP 2010	**6.1**	**2.5**	**2.7**	**3.0**	**3.0**
General government balance (% of GDP)	COM	-1.4	-3.7	-3.0	-2.4	n.a.
	PEP 2010	**-1.4**	**-3.4**	**-3.3**	**-3.1**	**-2.3**
Primary balance (% of GDP)	COM	0.1	-1.9	-1.1	-0.4	n.a.
	PEP 2010	**0.1**	**-1.9**	**-1.8**	**-1.7**	**-0.9**
Government gross debt (% of GDP)	COM	33.5	37.8	39.2	39.3	n.a.
	PEP 2010	**29.1**	**33.5**	**36.1**	**37.3**	**37.4**

Sources: Pre-Accession Economic Programme (PEP), Commission autumn 2009 forecast

1.2. INTRODUCTION

On 29 January 2010, Croatia submitted its sixth Pre-Accession Economic Programme, following government adoption and earlier consultation of social partners. The programme covers the period 2010-2012 and represents an update of the previous years' submission. It builds on earlier policy documents, such as the "Strategic Development Framework for 2006-2013" and the "Economic and Fiscal Policy Guidelines 2010-2012".

1.3. KEY CHALLENGES

The key medium-term challenges for Croatia will be to lay the foundations for a process of gradual economic recovery based on a sustainable growth pattern while preserving macroeconomic stability. In view of the large and rising external debt, this will require a careful macroeconomic management. To bring the growth of domestic demand in line with a sustainable level of external balances, fiscal policy needs to play a strong role. In turn, a process of continued fiscal consolidation requires significant expenditure reforms with a view to restructure current spending towards a more efficient and sustainable pattern. The depth of the current recession, which triggered painful and harsh real sector adjustments, also revealed structural weaknesses of the Croatian economy that need to be tackled urgently. This includes the design and swift implementation of concrete structural reforms in areas such as privatisation and corporate sector restructuring, social security, education, labour market, pubic administration and business environment. The Pre-Accession Economic Programme is meant to provide guidance for policy making and reform implementation.

1.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

1.4.1. Recent macroeconomic developments

The Croatian economy has been severely affected by the financial and economic crisis. Real GDP declined by 5.8% in 2009, driven by a strong fall in domestic demand. Private consumption decreased by 8.5% year-on-year and real investment by 11.8%. The recession has increasingly affected the labour market. The officially registered unemployment rate climbed to 16.7% at end-2009, compared to 13.5% a year before. The number of employed declined by 5.6% in the same period. As a result of shrinking domestic demand, annual inflation has fallen to 1.9% in December 2009, despite increases in VAT and excise taxes. Average inflation came down to 2.4% in 2009, significantly lower than the 6.1% in 2008. External deficits have narrowed as imports have been falling more strongly than exports. The current account deficit declined to 5.2% of GDP, down from 9.1% in 2008. After a temporary fall in the first half of 2009, official foreign currency reserves recovered and stood at EUR 10.4 billion at end-2009, equivalent to around 5.5 months of imports. The stock of external debt continued to increase, by 11% year-on-year, to EUR 44.6 billion or close to 98.3% of GDP at end-2009, as compared to 86.2% at end-2008.

Table II.1.2:

Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011		2012	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	2.4	**2.4**	-5.8	**-5.9**	0.2	**0.5**	2.2	**3.0**	n.a.	**3.5**
Contributions:										
- Final domestic demand	3.1	**3.1**	-8.1	**-8.4**	0.7	**0.3**	2.9	**3.2**	n.a.	**3.8**
- Change in inventories	0.4	**0.4**	-2.9	**-2.2**	0.2	**0.2**	0.0	**0.3**	n.a.	**0.4**
- External balance of goods and services	-1.3	**-1.3**	5.2	**4.7**	-0.7	**-0.1**	-0.6	**-0.6**	n.a.	**-0.7**
Employment (% change)	1.2	**1.3**	-1.0	**-2.7**	0.5	**-0.6**	0.5	**0.9**	n.a.	**1.6**
Unemployment rate (%)	8.6	**8.4**	10.2	**9.9**	10.0	**10.3**	9.6	**9.9**	n.a.	**9.1**
GDP deflator (% change)	6.4	**6.4**	2.8	**2.8**	3.0	**1.8**	2.5	**3.0**	n.a.	**3.0**
CPI inflation (%)	6.1	**6.1**	2.6	**2.5**	3.0	**2.7**	3.0	**3.0**	n.a.	**3.0**
Current account balance (% of GDP)	-9.3	**-9.2**	-6.1	**-5.7**	-6.7	**-6.0**	-7.4	**-6.3**	n.a.	**-6.5**

Sources: Pre-Accession Economic Programme (PEP); Commission Autumn 2009 forecasts (COM)

1.4.2. Medium-term macroeconomic scenario

The PEP 2010-2012 presents an overall comprehensive medium-term macroeconomic programme with projections for key economic variables, covering GDP and its demand components, employment and wages, inflation as well as balance of payments developments. Not surprisingly, the GDP growth projections differ significantly from last year's PEP scenario, which underestimated the effects of the global crisis on the domestic economy. The macroeconomic scenario appears somewhat optimistic. In particular, the key underlying determinants for the economic recovery in 2010 and the relatively strong growth acceleration in 2011 and 2012 are not fully elaborated. The PEP does not explicitly discuss alternative growth scenarios and would benefit from a more detailed assessment of risks related to the expected recovery from the strong recession in 2009.

The external assumptions of the PEP 2010-12 have markedly changed compared to the previous years' programme, in line with a considerably less benign external outlook. For 2010, the programme assumes world and EU 27 real GPP to grow by 2.9% and zero %, respectively, which is 1.3 percentage points lower than in last year's PEP. The world trade volume is assumed to expand by 1.2%, down from 6.4% in the previous PEP. Oil prices in 2010 are projected at 82.1 US-$ per barrel, which is 7.1 US-$ higher.

Real sector

The PEP projects that the Croatian economy will grow out of the recession during 2010. Real GDP growth is set to reach 0.5%, following an estimated decline of 5.9% in 2009, and to accelerate to 3% in 2011 and 3.5% 2012, thus assuming a V-shaped recovery. The resumption of growth is primarily driven by domestic demand, including a re-stocking of inventories. The PEP projects private consumption to grow by 0.4% in 2010 (after an estimated fall of 8.5% in 2009), as a result of increased consumer optimism, a moderation of employment losses and lower borrowing costs for private households. The acceleration of private consumption growth in 2011 and 2012 is explained by EU accession related expectations and wealth effects related to a gradual recovery of the value of financial assets. Investments are seen as an important pillar of the 2010 recovery. Investment growth is projected to reach 0.9% in 2010 (following an estimated decline of 11.3% in 2009), and to accelerate during the PEP horizon. The PEP does not elaborate on factors which could support the start of a new investment cycle in 2010, but highlights risks related to the availability and costs of financing for private businesses. After strong falls of international trade in 2009, both exports and imports are projected to increase in real terms in 2010 and to accelerate in 2011 and 2012. Total imports are set to grow more strongly than exports, leading to a negative contribution of net exports over the entire PEP period.

The PEP's growth scenario appears somewhat optimistic and does not provide a fully convincing explanation of the acceleration of private consumption and investment growth. Economic activity in the last quarter of 2009 continued to fall year on year. The annual rates of decline were more moderate compared to earlier quarters, but available data are not fully conclusive as to whether the recovery had already started in end 2009/early 2010. Prospects for growth resumption as outlined in the PEP remain very uncertain. Consumer confidence may not recover as quickly as assumed. The effects of the recession on the labour market, declining employment and rising unemployment, will continue to be felt in 2010, and possibly beyond. Bleak job prospects and low wage growth will limit the scope for a marked increase in disposable income and private consumption. Investment activity is likely to be constrained by elevated capital costs. Despite recent government measures to support lending through below-market interest rates and risk sharing, banks may remain reluctant to accelerate lending activity as they have to cope with further loss absorption. Furthermore, ongoing real adjustments in the construction and retail sectors as well as relatively high costs of external financing could prevent total investment growth to quickly turn into positive territory. Finally, parts of the corporate sector are suffering from the build up of inter-company debt and payments arrears, which additionally impedes on the re-launching of major investment projects in the relevant sectors of the economy.

On labour market developments, the PEP projects total employment to fall by 0.6% in 2010, after an estimated decline of 2.7% in 2009. In line with the projected economy recovery, a slight increase in employment levels is foreseen in 2011 (+0.9%) and 2012 (+1.6%). The unemployment rate (ILO) in 2010 is projected to increase to 10.3% (from an estimated 9.9% in 2009), and to fall to 9.1% at the end of the PEP horizon. Projections may underestimate the effects of the current deep recession on the labour market. Past evidence suggest, that labour market developments will follow the business cycle with a significant time lag, which could imply a period of "jobless" growth once recovery has started.

Inflation

Annual inflation fell significantly during 2009, to 1.8% in November, compared to 2.9% in December 2008, mainly as a result of a considerable weakening of domestic demand as well as lower commodity and energy prices. According to PEP estimates, average food price inflation declined from 10.6% in 2008 to 1.9% in 2009 and energy price inflation from 7.8% to minus 1.2%. This contributed significantly to the strong decline in annual average CPI inflation to 2.4%, down from 6.1% in 2008. The PEP projects a slight increase in average inflation over the PEP horizon to 2.7% in 2010, mostly arising from higher import prices for raw material and oil as the world economy and global demand gradually recover. At the same time, the exchange rate of the kuna against the euro is set to remain stable, thus providing a firm anchor for inflationary expectations. Domestic factors are not seen to trigger inflationary pressures, although the recovery is projected to be driven by a strengthening of domestic demand. The programme also assumes that cost push pressures remain limited as the growth of unit labour costs will slow down significantly.

The inflation outlook of the programme appears broadly reasonable. Risks of stronger-than-expected inflationary pressures over the short-term appear indeed limited, also in the context of the outlined policy mix. However, higher import prices and a deprecation of the domestic kuna vis-à-vis the US-Dollar may exert some price pressures. Moreover, necessary alignments of indirect taxes (e.g. excises) as well as further adjustments of administrative prices (mainly on energy) could add to price increases. Overall, however, those risks appear well manageable.

Monetary and exchange rate policy

The programme's basic assumption is that that the present policy framework of a tightly managed float and the core objective of price stability remain in place. For many years, exchange rate stabilisation has served the country well in preserving macro-financial stability and in anchoring inflation expectations. The PEP rightly argues that the choice for such a regime is also determined by the fact that Croatia is a small country with a relatively high external debt burden and large degree of euroisation. The latter implies significant risks due to balance sheets mismatches of the private corporate and non-corporate sector. Under these conditions, exchange rate stabilisation becomes an objective in itself to safeguard financial sector stability. Within those limitations, the central bank has been able to effectively mitigate the impact of the global financial crisis through a number of administrative and regulatory measures aimed at alleviating foreign exchange pressures and providing liquidity to the domestic banking sector. This included the abolition of marginal reserve requirements on banks' foreign borrowing, relaxations of reserve and liquidity requirements, effectively unfreezing banks' foreign currency holdings, as well as direct interventions on the foreign exchange market. In the course of 2009, external financing pressures eased; external borrowing by the government and the corporate sector led to large inflows of foreign exchange, triggering foreign exchange interventions to limit appreciation pressures on the domestic currency. More recently, the central bank reduced reserve requirements to free funds for a temporary subsidised lending scheme set up by the government.

Going forward, the policy framework has a number of important policy implications. If the economic recovery gets pace and net capital inflows start to grow (eg through government foreign borrowing), steering domestic liquidity and credit growth will become a challenging task, due to the limited scope for policy discretion. These constraints also imply, that the onus of macroeconomic management and adjustment will continue to be on fiscal policy. Further fiscal consolidation will reduce public sector's gross (external) financing requirements and thus support the stabilisation of the exchange rate and external debt. Taking these challenges into account, the fiscal scenario of the PEP does not look very ambitious, as assessed below.

External sector

A significant adjustment of the current account deficit took place during 2009 as a result of a strong decline in international trade volumes, whereby imports shrank more strongly than exports. The current account deficit narrowed to an estimated 5.7% of GDP, down from 9.2% in 2008. The PEP projects a gradual, but rather modest widening of the current account deficit by around 0.3 percentage points per year to 6.5% of GDP in 2012. The increase in the merchandise trade deficit (by around 2 percentage points) is only partly offset by a higher surplus in the trade with services, notably due to a recovery of income from tourism.

The external projections appear broadly plausible. However, the nature of the projected recovery as well as higher world commodity and energy prices could lead to a stronger-than-expected growth of imports and an earlier and more pronounced widening of the trade gap. The projected improvement of the net factor income balance (as a percentage of GDP) could be impeded by higher external financing costs and debt service payments on a growing external debt. Questions remain with respect to the structure of financing of the current account deficit over the PEP horizon. The PEP realistically projects net FDI flows to remain moderate, significantly below pre-crisis levels, but does not elaborate on other financing flows.

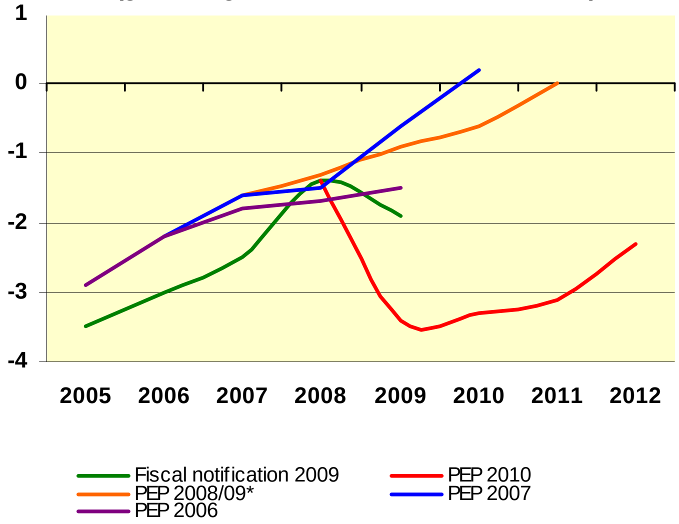
Main risks

Short-term risks to the macroeconomic scenario are clearly associated with a possible prolongation of the current recession. A slower recovery in the major EU trading partners will certainly affect prospects for an early resumption of growth as projected by the PEP. With respect to the medium term, the switch to a sustainable growth pattern could be challenged by domestic structural weaknesses emanating from labour market rigidities, a high regulatory burden, a lack of dynamisms and unresolved corporate sector restructuring. In addition, macro-financial risks are related to a high level of external debt and large short-term debt service obligations. The programme would have deserved a more in-depth discussion of options for matching external financing requirement over the medium term.

1.5. PUBLIC FINANCE

The objective of continued fiscal consolidation and deficit reduction remains appropriate, but challenging. In view of relatively high spending ratios, tight financing constraints and external vulnerabilities, fiscal policy should play a larger role in supporting a prudent and stability-oriented policy mix. However, the programme's fiscal scenario does not appear to be particularly ambitious. The overall magnitude of fiscal adjustment is limited and back-loaded with only little consolidation foreseen in 2010 and 2011. Moreover, the credibility of the fiscal programme suffers from the lack of information on envisaged supporting fiscal measures and their quantitative effects. Measures outlined in the policy matrix have relatively minor budgetary effects, and delays in policy implementation, in particular with respect to subsidy reduction and streamlining of social transfers, appear significant. Therefore, although fiscal targets are not particularly ambitious, they could still be missed. The programme does not provide for sufficient contingency planning in case of major deviations from the programmed fiscal path. Finally, the programme contains little evidence that the structure and composition of spending will change to support a more growth-oriented public finance strategy.

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



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

The fiscal programme envisages a gradual improvement of the consolidated general government balance, turning from an expected deficit of 3.4% of GDP in 2009 to a deficit of 2.3% of GDP in 2012 whereas the major part of adjustment takes place in 2012. The primary deficit, net of interest, is set to decline to the same magnitude (in percentage points of GDP), namely from 1.8% to 0.7% of GDP. Fiscal consolidation is based on a reduction of the public spending ratio (including net acquisition of non-financial assets) by around 4.1 percentage points of GDP in the three-year period (from 42.2% of GDP in 2009 to 38.1% in 2012). In particular, spending on social transfers, subsidies, wages, and other items is programmed to be reduced, as a share of GDP, while public investment and interest expenditure are set to remain rather stable. At the same time, the revenue-to-GDP ratio is planned to decline by 3 percentage points over 2009 to 2012, largely due to drops in direct taxes and in social contributions (in relation to GDP). The general government debt ratio is projected to increase by 3.9 percentage points, from 33.5% of GDP in 2009 to 37.4% of GDP in 2011, as the effects from additional net borrowing are stronger than the nominal GDP effect (increase in the denominator).

Box II.1.1: **The global financial crisis: impact and policy response**

The global crisis has severely affected the Croatian economy with a strong drop in output, falling employment, higher unemployment and public finances having become under increasing pressure. Although the decline in economic activity has somewhat moderated towards end of 2009 and early 2010, prospects for an early and pronounced recovery remain uncertain. External financing conditions seem to have eased somewhat and capital inflows have resumed. However, a large and rising stock of external debt and important short-term debt repayment obligations represent key challenges. After a temporary fall, official foreign exchange reserves have recovered and provide some cushion against external shocks. The mostly foreign-owned banking sector remained resilient and adequately capitalised during the crisis, as parent-banks have continued to be willing to roll-over current exposures. However, the share of non-performing assets has increased as a consequence of the deep recession. The build-up of sizeable inter-company debt and arrears may further aggravate financial problems and delay a swift economic recovery.

During 2009 and in early 2010, the Croatian authorities adopted a number of measures with a view to mitigating the effects of the crisis.

Monetary Policy – administrative and regulatory measures

- Abolishment of marginal reserve requirement on banks' foreign borrowing (October 2008)
- Reduction of banks' reserve requirement rate (November 2008) and changes in the currency composition of reserve requirements (January 2009)
- Foreign exchange interventions to mitigate temporary depreciation pressures of the domestic currency by selling euro (January and February 2009), and later to provide domestic currency liquidity through purchases of euro (February, September, October and December 2009)
- Reduction of minimum required reserves on foreign currency claims (February 2009)
- Lifting of restrictions on banks' credit growth (November 2009)
- Further reduction of banks' reserve requirement rate (February 2010)

Fiscal policy measures

- Three revisions of the 2009 budget, including measures to adjust for rapidly falling revenues such a temporary special tax on income ("crisis tax"), a VAT increase and excises on mobile communication
- Cost saving measures in 2009 and 2010 included: 10% wage reduction for state officials and judges and 6% for civil servants and public sector employees in 2009, lowering of unemployment benefits, 10% reduction of some privileged pensions and suspension of pension indexation in 2010, planned cuts in subsidies in 2010
- Stimulation of credit activity to support viable firms through below market interest rates and partial government guarantees (not part of the PEP 2010)
- Subsidies for loans for first-time buyers of real estate (not part of the PEP)

1.5.1. Budget implementation in 2009

The global crisis led to a deep recession in Croatia and brought its public finances under severe pressures, necessitating subsequent budgetary adjustments in the course of the year. The original budget framework adopted in late 2008 foresaw a deficit target for the consolidated general government sector of 1.1% of GDP, down from 1.4% in 2008. It turned out that the budget was based on overly optimistic macroeconomic assumptions. Fiscal performance deteriorated significantly in early 2009 with severe drops in revenues. The government adopted a first budget revision in April, followed by two further revisions in July with more realistic growth assumptions. In this context, a number of fiscal adjustment measures were taken to compensate for rapidly falling revenues, such as a VAT increase, a special tax on income and higher excises. Efforts to contain current spending (decrease in public sector wages, suspension of pension indexation, cuts in material spending) were however partly offset by additional outlays (e.g. increases in agricultural and employment subsidies). The planned balance deteriorated markedly to 3.4% of (the revised) GDP, raising gross financing requirements in times of tight financing constraints.

Table II.1.3:

Consolidated general government finance in 2008 and 2009 (in billions of kuna) (1)

	2008	2009				
	Outcome	Original budget	First Revision April	Second revision July	Third revision July	Budget execution (2)
Total revenue	134.8	143.4	134.6	127.0	128.4	128.1
Total expenditure	139.5	147.2	141.1	139.8	139.5	141.7
Deficit	-4.7	-3.8	-6.4	-12.8	-11.2	-13.6
Deficit in % of GDP	-1.4	-1.1	-1.9	-3.8	-3.4	-4.1

(1) in ESA 95 terms (2) MoF preliminary estimates

According to available budget statistics, the actual budget implementation appears to have been rather in line with the budget plan (third revision). However, in late 2009 some overruns in current spending occurred, in particular on wages, pensions as well as on social transfers. In order to remain within (or close to) the total spending envelope, the government had to revert to some ad-hoc measures, including a reduction of Christmas bonuses and a major re-allocation of budget funds (equivalent to 2.5% of GDP). This included a postponement of payments (e.g. for subsidies on housing savings and Christmas bonuses) to the next year, which will inevitably have to be borne by the 2010 budget. Despite last minute adjustment, the PEP reports, that the budget deficit is likely to exceed the planned level, mainly due to an activations of state guarantees. Indeed, according to latest available information from the Ministry of Finance, the 2009 deficit overshot its target by around 0.7% of GDP, reaching 4.1% of GDP.

1.5.2. Near-term and medium-term budget strategy

The PEP's fiscal projections for 2010 are based on the present budget framework adopted in December 2009. To a large extent, the 2010 budget plan appears to be based on a "no policy change" assumption, looking rather similar to the previous years' budget. The PEP does not introduce any significant fiscal measures, neither on the revenue, nor on the spending side of the budget. The 2010 budget can thus hardly be considered a reflection of the government's key reform priorities outlined in the programme. It projects small increases in total revenues (1.3% year-on-year) and expenditure (1.1%). As a share of GDP, they are projected to fall by 0.4 and 0.5 percentage points, respectively. Accordingly, the general government deficit is set to decline marginally compared to the 2009 plan, to 3.3% of GDP.

Table II.1.4:

Composition of the budgetary adjustment (% of GDP)

	2008	2009	2010	2011	2012	Change: 2009-12
Revenues	39.4	38.8	38.4	36.8	35.8	-3.0
- Taxes and social security contributions	35.0	34.5	34.3	32.8	32.1	-2.4
- Other (residual)	4.4	4.3	4.1	4.0	3.7	-0.6
Expenditure	40.8	42.2	41.7	39.9	38.1	-4.1
- Primary expenditure	39.3	40.7	40.2	38.5	36.6	-4.1
of which:						
Gross fixed capital formation	2.0	1.8	1.9	1.9	1.8	0.0
Consumption	0.0	0.0	0.0	0.0	0.0	0.0
Transfers & subsidies	18.0	19.5	19.0	18.0	17.1	-2.3
Other (residual)	19.3	19.4	19.3	18.6	17.7	-1.7
- Interest payments	1.5	1.5	1.5	1.5	1.5	0.0
Budget balance	-1.4	-3.4	-3.3	-3.1	-2.3	1.0
- Cyclically adjusted	-2.6	-2.6	-2.6	-2.6	-2.6	0.0
Primary balance	0.1	-1.9	-1.8	-1.7	-0.9	1.0
Gross debt level	29.1	33.5	36.1	37.3	37.4	3.9

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

Despite the fact, that the 2010 budget may be considered as a "carry-over" from last years' budget, it carries risks of revenue underperformance and spending overruns. As stated in the programme, the projected growth of revenues may partly benefit from the full-year effects of tax increase adopted during 2009 (VAT, temporary crisis tax on income, excises). However, as outlined above, the budget's underlying GDP growth assumptions may appear too optimistic which raises doubts about revenue performance. In particular, the revenues from VAT could turn out to be much lower under a less benign economic recovery scenario, due to relatively high tax elasticity.

Despite the PEP's emphasis on continued fiscal consolidation, the 2010 budget foresees increases in current primary spending, particularly on social transfers (pensions, child allowances, and unemployment benefits) and public sector wages (together around HRK 1.1 billion). Moreover, an amount of HRK 2 billion was set aside for EU accession related programmes. Interest payments are projected to rise by HRK 1 billion. Interestingly, increases in spending are set to be partly compensated, including through a significant reduction of the level of planned subsidies, by around HRK 1 billion, or 13.6% year-on-year. The PEP projects the main beneficiary of subsidies to receive less state support, such as the agricultural, railway, shipbuilding and maritime transport sectors. However, the implementation of subsidy cuts in these sectors remains challenging. There appears to be strong domestic opposition against the planned changes to the agricultural state aid system. Prospects for shipyard privatisation and restructuring remain uncertain, perpetuating the need for budget transfer and risking activation of government guarantees. Similarly, state support for the railways is likely to remain high, due to the slow progress of reforms to enhance the efficiency of the sector. In addition, the government took a number of ad-hoc measures in late 2009, such as an increase in subsidies to partly compensate for higher gas prices. Moreover, as mentioned earlier, some payments under the 2009 budget were carried over into 2010, thus increasing spending level on a cash basis. Finally, the government recently adopted new subsidies for housing loans, the fiscal effects of which remain unclear.

The PEP projects the 2011 budget to be characterised by a relatively sharp fall in revenues, by 1.6 percentage points of GDP, which takes into account the planned abolition of the temporary crisis tax on income at end-2010. Nonetheless, the general government deficit is set to continue to fall to 3.1% of GDP, as total expenditure are projected to decline slightly more strongly than revenues. Interestingly, the largest part of fiscal adjustment over 2010-2012 takes place in 2012, when the general government deficit is set to decline to 2.3% of GDP. A major part of adjustment over the years

2011 and 2012 is planned to be realised through a reduction of primary spending with a particularly strong contribution of spending on social benefits (1.1 percentage points), wages (0.7 percentage points), intermediate consumption (0.5 percentage points), and subsidies (0.3 percentage points). Unfortunately, the PEP does not provide detailed information on fiscal measures which could support the envisaged reduction of spending (e.g. by 1.8 percentage points per year) in 2011 and 2012. To support its credibility, the PEP should have outlined in more detail the costs saving measures underlying the government's fiscal strategy.

As mentioned, fiscal risks are clearly related to the rather optimistic growth assumptions of the programme (see below 3.3). At the time of PEP submission, the Croatian economy was still in recession and prospects for an early recovery remained uncertain. It was evident that a scenario of economic stagnation or even a slightly negative output growth in 2010 was in the range of possibilities. Such a scenario would inevitably imply lower revenues and a larger fiscal deficit, as the scope for counterbalancing measures on the spending side appear limited. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings. This refers particular to the planned reduction of the level of subsidies, as outlined above. The authorities may also be confronted with continued spending pressures, resulting from measures taken to revive the economy. A growing public debt, which is partly projected to be re-financed on foreign market, may imply financing risks resulting from a larger debt service burden.

1.5.3. Structural balance

The PEP 2010-2012 provides estimates on the cyclical position of the economy and structural balances, applying the same standard methodology as in last year's submission. Due to the severe recession in 2009, potential GDP growth rates have been significantly adjusted downwards for each year. As a result of the projected recovery starting in 2010, projected growth rates exceed potential growth rates in each year over the PEP horizon. This supports a gradual reduction of the negative output gap until 2011, before it turns positive in 2012. The cyclically adjusted primary balance improves in 2010, deteriorates in 2011, and remains broadly unchanged in 2012. On this basis, the PEP concludes that fiscal policy has slightly restrictive and pro-cyclical effects in 2010, and turns countercyclical in 2011 and 2012. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with a great deal of caution. There remains scope for deepening the analysis in future submissions.

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

The PEP 2010-2012 projects a baseline scenario of a gradual increase of public debt from 33.5% of GDP in 2009 to 37.4% in 2012.([3]) Projections on the decomposition of changes in the debt ratio show that its deterioration is largely driven by the negative primary balance and interest payments in each year over the PEP horizon. Growth and inflation effects can only partly compensate for this. Stock-flow adjustments are projected to have a minor effect, at 0.1% of GDP.

The PEP contains a debt sensitivity analysis which reveals that the public debt ratio is particularly sensitive to a depreciation of the kuna-euro exchange rate, as around 80% of outstanding public debt is denominated in foreign currency, mostly in euro. A 25% depreciation of the Kuna, admittedly a rather extreme ad-hoc assumption, would lead to an increase in public debt to 50% of GDP. However,

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

other scenarios show that the debt ratio could easily jump by more than 10 percentage points at the end of the PEP horizon.([4])

The projected levels of public debt do not give rise to immediate concerns about debt sustainability. However, the sensitivity analysis as well as discussion of fiscal risks underlines the need for a prudent fiscal policy. Potential risks also result from a significant increase in public sector financing requirements in 2010 and 2011, also related to the re-financing of maturing debt. Finally, recently adopted and planned financial support measures for the corporate sector imply an increase in contingent liabilities with possible effects on public debt in the future. Unfortunately, the programme does provide only scattered information about the government re-financing strategy and potential risks resulting from contingent liabilities.

Table II.1.5:

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

	2008	2009	2010	2011	2012
Gross debt ratio [1]	**29.1**	**33.5**	**36.1**	**37.3**	**37.4**
Change in the ratio	-4.0	4.4	2.6	1.2	0.1
Contributions [2]:					
1. Primary balance	**-0.1**	**1.8**	**1.4**	**1.3**	**0.7**
2. “Snow-ball” effect	**-1.2**	**2.5**	**1.1**	**-0.2**	**-0.6**
Of which:					
Interest expenditure	1.5	1.6	1.9	1.8	1.7
Growth effect	-0.7	1.8	-0.1	-1.0	-1.2
Inflation effect	-1.9	-0.9	-0.6	-1.0	-1.1
3. Stock-flow	**-2.8**	**0.1**	**0.1**	**0.1**	**0.1**

Notes:

[1] End of period.

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

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

1.5.5. Budgetary implications of major structural reforms

The programme presents estimates of the fiscal impact of structural measures in various policy fields envisaged over the PEP horizon. A summary overview is presented in table II.2.5 of this assessment. It shows that the overall net impact on the country's fiscal position is very small at around 0.02% of GDP per year on average. Most of the measures presented in the Policy Matrix of the programme have indeed a negligible effect on the budget. Apart from the planned reduction of subsidies to the railways, agriculture and shipbuilding sector, the matrix does not include any noticeable cost saving measures. Net increases in spending are projected to result from infrastructure investments in the health sector as well as from labour market measures envisaged to stimulate employment. Overall, the policy matrix confirms that the programme is broadly preserving a "status quo" rather than outlining a strong expenditure and revenue reform agenda.

1.5.6. Sensitivity analysis and comparison with previous programme

The PEP 2010-2012 includes an update of the sensitivity analysis presented in last year's submission. The first scenario assumes lower real growth rates of private consumption, namely a zero growth in 2010 and a 50% lower growth rate in 2011, as compared to the baseline scenario. This leads to a deterioration of the fiscal balance by 0.3 percentage points in 2010, and by 0.6 points per year in 2011

([4]) In the case of an increase in contingent liabilities and a real GDP shock (i.e. no real growth in 2010 and 2011) and 2012. The second scenario assumes a lower growth of revenues from personal income tax and social contributions (i.e. a fall by one percentage point in 2010 and 2011) due to labour market problems. This would result in deviations from baseline fiscal balances by around 0.3 percentage point per year on average. Finally, the third scenario assumes a combination of the two previous scenarios. Unsurprisingly, the combined effect on the fiscal balance is much stronger, amounting to 0.9 percentage points in 2012. The analysis is useful in demonstrating the high sensitivity of the fiscal balance to changes in real consumption and revenue growth. It confirms that relatively modest deviations from the baseline scenario can lead to a marked deterioration of public finance over the PEP horizon. It would have been useful to expand the analysis by including a set of more severe shocks to growth and revenues. The PEP does not elaborate on possible counterbalancing measures to be taken in the event of risk occurrence. It thus remains unclear how the fiscal strategy could respond in the short term in case significant deviations from the outlined fiscal path occur.

As the PEP points out, a comparison with the previous years' programme is difficult and of limited use, due to a number of factors. First, a major GDP revision took place in early 2009, raising GDP in current prices and thus the denominator for the calculation of fiscal ratios rather significantly. Secondly, the previous years' PEP macro and fiscal framework became quickly outdated as it underestimated the effects of the crisis on the Croatian economy. As a consequence, the 2009 fiscal programme was significantly adjusted in the course of three budget revisions. Finally, the PEP refers to the use of different coverage of the general government sector in the two programmes([5]), however, without providing additional information as to underlying reasons for and the scope of changes in methodology.

1.5.7. Quality of public finance and institutional features

The PEP 2010-2012 refers to recent and ongoing institutional reforms which are seen to improve the quality of public finances over the medium term. According to the PEP, the new Budget Act which came into force in early 2009 should enable a more strategic budget planning in the context of a three-year budget framework. Moreover, the programme provides a short overview of ongoing or planned reforms of the state treasury, internal financial control system, judiciary, public procurement, employment legislation and management of public investment projects.

However, the PEP lacks a vision and a strategy in addressing key policy challenges. There is considerable scope for a rationalisation and streamlining of public expenditure and in particular a better targeting of social spending. Low employment and participation rates may imply the need for reforms of the tax-benefit system, including a reduction of relatively high payroll taxes which effect on labour demand and disposable income. The simplification of the tax system is, contrary to earlier submissions, no longer mentioned as a policy priority. Also contrary to earlier programmes, this years' PEP does not explicitly express intentions to shift the composition of the budget toward growth-enhancing expenditure. No specific information is provided on public investment plans over the medium-term. Overall, the PEP would benefit from presenting a more convincing policy strategy to improve the quality of public finances through concrete revenue and expenditure measures.

1.5.8. Sustainability of public finance

The PEP 2010-2012 contains a short analysis of the long-term sustainability of public finances with a focus on pension, health and interest expenditure. Assumptions on long-term population trends have not been changed compared to last year's PEP. Differences to last year's projections result primarily from a major GDP revision in early 2009 and revised medium-term projections for GDP growth, unemployment levels and fiscal aggregates. Total expenditures are projected to increase from 41.7% of GDP in 2010 to 42.2% in 2050, while total revenues are set to fall from 38.4% to 35.5% during the

([5]) In one sentence on page 34.

same period. Spending on old-age pensions is also expected to decline from 8.7% of GDP in 2010 to 6.9% in 2050, as a larger share of pensions is expected to be paid by the second pillar. Pension contributions would stay at around 5.3% of GDP as of 2015. Health care spending is set to increase markedly from 6.5% of GDP in 2010 to 10.5% in 2050, mainly as a result of an ageing population.

The challenges of an ageing society remain significant also in view of an already relatively high public debt ratio and a very low participation rate. Moreover, long-term sustainability could be further eroded, if growth and productivity trends turned out to be less comfortable and if participation rates fell below levels assumed under the programme. The programme does not explicitly relate its long-term projections to a set of concrete reform measures (e.g. in the area of pension, health care or labour markets) which would improve the long term sustainability of public finance. Some short-term pension measures have been taken in 2009 (e.g. suspension of pension indexation in 2010, cut of some privileged pensions) and will provide limited fiscal relief. Further parametric reform of the first pension pillar (e.g. minimum pension, retirement age, equalisation of rights between men and women) are only mentioned as a possibility, but do not form part of the programme's policy matrix. Nor does the programme envisage a comprehensive reform and rationalisation of privileged pensions (accounting for 20% of total pension expenditure), although the urgency is widely recognised and has been publicly announced by domestic policy makers. Important initial health reform measures were taken recently to enhance the system's revenue base and to ensure cost savings (especially on sick leave and medicines). The programme takes a rather short-term view when it suggests that the measures resulted in a financial stabilisation of the health care system. In view of an ageing society, putting health care financing on a sustainable path will require further rationalisation efforts, including a thorough review of the co-payments system as well as a rationalisation and better utilisation of hospital care, including tackling excess supply. Overall, the programme would have benefited from outlining a somewhat more thorough policy response to the challenges of an ageing society.

1.6. STRUCTURAL REFORMS

The PEP covers a broad range of structural reform areas identical to last years' programme, The programme does not fully and consistently establish a clear link between the core objectives and the instruments and measures. To serve as a useful guidance for the implementation of structural reforms, the programme would benefit from the definition of clear policy targets, concrete measures and a time frame for implementation. More emphasis should have been given to measures to improve the business environment, given the pertaining administrative obstacles still in place. The programme contains fiscal estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy is generally weak and could be further strengthened. The programme falls short in fully addressing the economic priorities of the Accession Partnership and the key challenges identified in the 2009 Progress Report. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would be supportive to the fulfilment of the second Copenhagen economic criteria.

Table II.1.6:
Net direct budgetary impact of key reform commitments (in thousand EUR)

	2010	2011	2012
Enterprise restructuring and subsidies	28,088	30,421	-24,173
Labour market reforms	-19,965	-19,488	-8,925
Agriculture and rural sector	67,826	11,362	4,385
Health care reforms	1,176	-19,852	-13,139
Other reforms	-46,574	-96	-106
Total impact on the budget	30,550	-13,879	-56,310
Total impact on the budget (in % of GDP)	0.07	-0.03	-0.11

Source: 2010 Pre-accession Economic Programme (PEP), own calculations, a minus sign indicates a deteriorating of the budget balance

1.6.1. Product and capital markets

The PEP 2010-2012 touches upon a number of reform areas related to the functioning of product markets, such as competition policy, privatisation, railway and shipyard restructuring, energy and SME development. The programme admits weaknesses in pursuing an effective competition policy and links them to weak competences of the Competition Agency in detecting and punishing anti-competitive behaviour of market participants. A new competition act which became effective in early 2010 is seen to strengthen the legal framework and the authority of the agency. The process of privatisation of state assets held in the Privatisation Fund has made very limited progress, partly as a result of the crisis. In September 2009, the fund's portfolio still comprised 783 companies, in 84 of which the state is a majority owner. The completion of privatisation remains a declared economic policy objective, but a clear time frame for selling or liquidating state assets is missing (except for the shipyards). The PEP refers to the idea to establish new models and institutional frameworks, however, it remains unclear how those could simplify and accelerate the privatisation process. The privatisation of six shipyards is foreseen for 2010. Following the first failed attempt in 2009, a second round of tenders was issued in February. With respect to loss-making railway sector, the programme refers to legal and institutional measures taken (e.g. to improve market regulation and railway safety), but does not specify concrete restructuring targets (e.g. operating ratios, staff levels) and measures to enhance the sector's productivity and to ensure its competitiveness once passenger and freight markets are fully liberalised. Finally, the programme fails to address present shortcomings in the overall business environment, including weaknesses in the regulatory framework and inefficiencies in public administration.

The alignment of financial sector legislation and in particular prudential regulations with EU requirements appears to be well on track. In particular, new capital adequacy rules for banks (which prescribe a minimum ratio of 12%) will be effective as of 31 March 2010. Banks' capital adequacy, asset quality and profitability have remained at relatively comfortable levels, although non-performing loan ratio has increased as a result of the crisis.

1.6.2. Labour market

Notwithstanding the severe effects of the current recession on employment levels and the number of unemployed, the Croatian labour market also suffers from deep-rooted structural problems, as evidenced by very low participation and employment rates as well as high rates of youth and long-term unemployment. The policy response of the programme continues to focus on active labour market measures, including recently adopted wage subsidies to partly compensate for the reduction of weekly working hours. However, as mentioned in last year's assessment, a more comprehensive reform approach would seem to be required to tackle structural deficiencies of the Croatian labour market. In particular, labour supply disincentives appear to be linked to a number of factors, such as a low effective retirement age, built-in incentives for early retirement and generous social welfare benefits for parts of the population. At the same time, it should be noted that unemployment benefits were reduced significantly in 2009 with a view to contain the fiscal effects of the crisis. In line with EU requirements, labour market policies should pay sufficient attention to tackle skill mismatches and to develop strategies of long-life learning.

1.6.3. Other reform areas

Other reform areas cover the agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform measures and initiatives with a strong emphasis on legislative action. Harmonisation with EU requirements has been treated with priority and seems rather advanced. The programme would have benefited from discussing the relevance of envisaged reforms in the context of its key policy objectives.

1.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework. The programme presents a clear and concise picture of past economic developments and covers most relevant data in an accurate way. Weaknesses remain with respect to data on sector's savings-investment balances. The PEP presents a sufficiently comprehensive and broadly consistent medium-term macroeconomic framework.

Fiscal framework. The fiscal programme is broadly consistent with the macroeconomic framework. However, the programme's fiscal targets for 2010 and 2011 do not entirely support the programme's notion of "fiscal consolidation". The programme would benefit from more concrete information on the envisaged fiscal policy measures, in particular on those to rein in current spending. The programme makes an effort to present fiscal data according to ESA standards. Historic data are fully in line with data submitted in the context of the 2009 fiscal notification. Unresolved issues remain with respect to the coverage of the general government sector as a number of "quasi-fiscal activities" (such as e.g. Croatian Bank for Reconstruction and Development (HBOR), Croatian Highways) and a large number of municipalities are not included in the fiscal programme of the PEP. PEP submissions would benefit from an explanation of operations and future plans of HBOR and Croatian Motorways.

Structural reforms. This part of the programme would benefit from a more coherent and consistent presentation of the structural reform agenda, better linking individual reform measures to the programme's key economic objectives and the fiscal strategy.

Table II.1.7:

Annex: Structural indicators

	Croatia					EU 27				
	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
General economic background										
Real GDP [1]	4.2	4.7	5.5	2.4	-5.8	2.0	3.2	2.9	0.8	-4.2
Labour productivity [2]	70.5	72.2	74.6	76.0	74.2	100	100	100	100	100
Real unit labour cost [3]	-0.4	-10.2	-0.7	1.4	3.8	-0.6	-1.2	-0.6	0.5	2.2f
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	107.5	106.4	107.9	114.0	n.a.
Inflation rate [5]	3.0	3.3	2.7	5.8	2.2	2.2	2.2	2.3	3.7	1.0
Unemployment rate [6]	12.7	11.2	9.6	8.4	9.6	8.9	8.2	7.1	7.0	8.9
Employment										
Employment rate [7]	55.0	55.6	57.1	57.8	n.a.	63.5	64.5	65.4	65.9	n.a.
Employment rate - females [8]	48.6	49.4	50.0	50.7	n.a.	56.3	57.3	58.3	59.1	n.a.
Employment rate of older workers [9]	32.6	34.3	35.8	36.7	n.a.	42.3	43.5	44.6	45.6	n.a.
Long term unemployment [10]	7.4	6.7	5.9	5.3	n.a.	4.1	3.7	3.1	2.6	n.a.
Product market reforms										
Relative price levels [11]	68.7	72.6	71.8	75.9	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	30.7	32.3	32.5	32.1	n.a.	9.8	10.7	10.8	11.4	n.a.
Net FDI [13]	3.4	6.5	8.2	6.7	4.5e	1.7	2.3	3.8	2.2	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	0.5	n.a.	n.a.
Business investment [16]	3.0	4.0	n.a.	n.a.	n.a.	17.7	18.2	18.7	18.4	n.a.
Knowledge based economy										
Tertiary graduates [17]	5.7	6.0	6.8	n.a.	n.a.	13.2	13.0	n.a.	n.a.	n.a.
Spending on human resources [18]	4.0	4.1	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	93.8	94.6	95.3	95.4	n.a.	77.5	77.9	78.1	78.5	n.a.
R&D expenditure [20]	0.9	0.8	0.8	0.9	n.a.	1.8	1.9	1.9	1.9	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

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

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

Source: Commission services, national sources

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

The Pre-Accession Economic Programme for 2010 - 2012 (the "2010 PEP") of the former Yugoslav Republic of Macedonia is based on a plausible economic scenario for 2010 but may be slightly on the optimistic side as regards recovery in the remaining period. The fiscal strategy appears feasible and is in line with the budget for 2010 and the country's medium-term fiscal strategy. The description of structural reforms is rather broad but lacks a discussion of policy priorities. The links to EU accession related priorities are not very pronounced. Concerning content, form and data, the programme partly complies with the requested standard. However, the quality of the presented data has clearly deteriorated compared to last year's submission.

The country weathered the global financial crisis relatively well, with a limited drop in GDP by about 0.7% in 2009, an increase in the fiscal deficit to 2.7% of GDP, a strong correction of external imbalances and a continued decline of registered unemployment. Like in the past, the main accession related challenges are to address the still substantial labour market imbalances and to strengthen administrative and institutional capacities, in order to improve the quality of public administration, but also to strengthen the rule of law.

The macroeconomic scenario envisages a significant acceleration of economic growth, notably in 2011 and 2012, which appears rather optimistic in view of the current economic environment. The programme presents estimates on the fiscal impact of alternative macro scenarios. However, in contrast to last year, the programme does not contain forecasts of external balances for 2011 and 2012.

The authorities achieved the 2009 fiscal target of a deficit of 2.7% of GDP. However, the original budget proposal had envisaged significantly higher revenues and expenditures and the repercussions of the crisis on the former required a hasty adoption of two supplementary budgets. The fiscal impact of the announced anti-crisis measures has remained very limited, as some key measures, such as the tax amnesty for some accumulated payment arrears, had a very small effect on actual revenues or spending. The fiscal framework for the programme period appears overall feasible and sustainable within the projected macro framework. However, very little information is provided on concrete planned measures. The data are sometimes incomplete and inconsistent and leave significant room for improvement.

The country's structural reform programme claims to support the establishment of a functioning market economy, particularly by improving the business climate and strengthening the competitiveness of the country's enterprises. The presentation of the measures appears to be incomplete. However, the government's attention is apparently shifting towards a few sectors (agriculture and infrastructure), leaving little scope for accession related priorities.

Overall, the programme presents a slightly optimistic macroeconomic scenario, while the fiscal framework appears largely in line with the macroeconomic framework. However, there appears to be a significant risk that in case of lower growth, the already optimistic revenues projections will also be significantly lower than expected. The prioritisation of structural reforms would have benefited from a closer alignment with the reform requirements in view of the country's EU accession perspectives, for example as spelled out in the latest Progress Report and the European Partnership.

Table II.2.1:

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP growth (% change)	COM	4.9	-2.0	1.5	2.5	n.a.
	PEP 2010	**4.8**	**-0.6**	**2.0**	**3.5**	**5.0**
Consumer price inflation (%)	COM	8.3	-0.6	1.1	2.2	n.a.
	PEP 2010	**8.3**	**-0.8**	**2.0**	**2.0**	**2.5**
General government balance (% of GDP)	COM	-1.0	-4.0	-3.5	-3.3	n.a.
	PEP 2010	**-1.0**	**-2.8**	**-2.5**	**-2.5**	**-2.0**
Primary balance (% of GDP)	COM	-0.3	-3.3	-2.8	-2.6	n.a.
	PEP 2010	**-0.3**	**-2.2**	**-1.6**	**-1.6**	**-1.0**
Government gross debt (% of GDP)	COM	20.8	25.5	28.3	30.3	n.a.
	PEP 2010	**21.3**	**24.7**	**26.5**	**27.1**	**27.9**

Sources: Pre-Accession Economic Programme (PEP), Commission autumn 2009 forecast

2.2. INTRODUCTION

The former Yugoslav Republic of Macedonia submitted its fourth PEP on 15th February 2010, covering the period 2010-2012. The programme has been adopted by the government. It is a joint document based on contributions of a large number of line ministries and the Central Bank, under the coordination of the Ministry of Finance. Social Partners and the business community appear not to have been involved in the drafting of the document. The programme takes into account the 2010 budget and other national programmes, such as the National Development Plan, the fiscal strategy for 2010-2012 and the National Plan for the Adoption of the Acquis (NPAA). However, the link to the country's accession process, such as the European Partnership priorities and the Commission's assessment in the Progress Report is weak.

The document partly complies with the content, form and data required for this exercise. It contains a general overview of recent economic developments and presents a parsimonious macroeconomic framework. The document describes key medium-term fiscal and other policy objectives and provides an overall presentation of structural reforms of product and capital markets in the light of EU-integration. However, the presented structural reform measures are poorly linked to the overall programme, with little quantitative information and in most cases with only a rough timetable. The document includes a large part of the quantitative information required. However, the completeness and consistency of the provided data leaves significant room for improvement. Furthermore, a significant share of the data, in particular the fiscal data, is not yet in line with ESA 95 requirements.

2.3. KEY CHALLENGES

The economic developments during the last months of 2009 point to a number of important policy challenges, in particular mitigating the impact of the global financial crisis and using the fiscal space in an efficient and prudent way. Addressing the very high unemployment overall, and among the young in particular, remains another important medium-term issue.

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

2.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

2.4.1. Recent macroeconomic developments

In response to the deteriorating external environment, economic activity started to slow down at the end of 2008 and continued to decline, at a moderate but accelerating speed during the first three quarters of 2009. However, in the fourth quarter output increased by 1.2%, reducing the annual decline to -0.7%, compared to GDP growth of 4.8% in 2008. Sharply falling exports and investment were the main sources for the decline, while rather stable private consumption helped to contain the drop in economic activity. In line with the sharp fall in investment and exports, imports dropped markedly. This resulted in a significant improvement of the trade deficit, from 27% of GDP end of 2008 to 24% at the end of 2009. Inflows of current transfers benefitted from higher private transfers and increased further from 15% of GDP in 2008 to 17% in 2009. This helped to reduce the current account deficit from 13% of GDP in 2008 to 7½% in 2009. Thanks to the downward trend of international food prices and also of energy and basic metals prices, overall consumer prices dropped by 0.8% in 2009, compared to an average CPI increase by some 8.3% in 2008, The slowdown of economic activity had a negative impact on tax revenues, which led to an increase in the public sector deficit, from about -1% of GDP in 2008 to around -2.8% in 2009. The labour market situation appears to have remained rather stable. In some industries (textiles, steel) employment declined; however increased employment in trade and transport, in the construction sector and on municipal level appear to have largely compensated those job losses.

Table II.2.2:

Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011		2012	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	4.9	**4.8**	-2.0	**-0.6**	1.5	**2.0**	2.5	**3.5**	n.a.	**5.0**
Contributions:										
- Final domestic demand	11.1	**10.0**	-4.4	**-1.5**	2.0	**4.7**	2.6	**8.0**	n.a.	**10.3**
- Change in inventories	0.2	**1.3**	0.0	**0.0**	0.0	**0.0**	0.0	**0.0**	n.a.	**0.0**
- External balance of goods and services	-6.5	**-6.5**	2.4	**0.9**	-0.6	**-2.7**	0.0	**-4.5**	n.a.	**-5.4**
Employment (% change)	3.2	**3.2**	-2.7	**3.5**	-0.5	**3.0**	0.1	**3.0**	n.a.	**4.0**
Unemployment rate (%)	33.8	**33.8**	35.6	**32.1**	36.1	**30.8**	36.4	**29.4**	n.a.	**27.8**
GDP deflator (% change)	7.3	**7.3**	1.4	**0.1**	1.3	**2.0**	2.3	**2.0**	n.a.	**2.5**
CPI inflation (%)	8.3	**8.3**	-0.6	**-0.8**	1.1	**2.0**	2.2	**2.0**	n.a.	**2.5**
Current account balance (% of GDP)	-13.1	**-13.1**	-9.6	**-8.0**	-9.2	**-9.4**	-8.9	**n.a.**	n.a.	**n.a.**

Sources: Pre-Accession Economic Programme (PEP); Commission Autumn 2009 forecasts (COM)

2.4.2. Medium-term macroeconomic scenario

Compared to last year's submission, the overall macroeconomic scenario is more realistic. Estimates for 2011 and 2012 appear to be somewhat optimistic, in particular when considering the programmes' expectation of strong growth of exports and domestic and foreign investment against the context of a rather moderate recovery of the euro area, which is the country's main export destination. However, overall, the envisaged GDP growth profile appears achievable, assuming that the country will increasingly be able to realise its growth potential.

The medium-term scenario expects a rather broad based economic recovery, driven by strengthening private consumption and increased investment, but also supported by external demand. Overall, GDP growth is forecast to reach 2% in 2010 and to increase to 5% by 2012. Employment is expected to increase by some 3-4% annually, which in combination with high wage growth and moderate inflation should help to boost consumption driven growth. Investment is expected to return to pre-crisis levels

Box II.2.1: The global financial crisis: Impact and policy response

The main transmission channels of the financial crisis on the economy were exports and investment, whose sharp drop was accompanied by an even stronger decline in imports. This led to a narrowing of the trade deficit by 4 % of GDP and to a substantial improvement of the current account. The financial sector weathered the global financial crisis relatively well, benefitting from low exposure to toxic assets, a strong focus on deposit based lending and a well functioning financial sector regulation and supervision.

Since December 2008, the government has announced four anti-crisis packages, partly consisting of tax reliefs, write-offs of unpaid debt of some troubled companies or the announcement of bold investment plans. In terms of actual additional spending, available data suggests a rather marginal impact on public sector revenues and spending. The programme claims significant positive effects of the government's anti-crisis measures on the country's economic performance. However, no further quantitative details were provided, neither on the size of the fiscal stimulus package nor on the fiscal impact of the crisis.

In response to rapidly shrinking foreign exchange reserves, the central bank raised interest rates at the beginning of 2009 but has lowered policy rates again towards the end of the year.

by 2010 and to increase by 13%-14% during 2011 and 2012. As a result of strong employment growth of some 3-4% annually during the programme period, unemployment is expected to drop significantly, from 32% in 2009 to 28% in 2012. Real wages are expected to drop by 4% in 2010 and to increase by some 4-5% in 2011 and 2012. Such real wage growth significantly above productivity growth would likely lead to a deterioration of price competitiveness at a time where the country's export sector is facing a challenging global environment. The sharp drop in wages in 2010 raises doubts on the feasibility of a strong growth of private consumption in the same year, while the high wage growth in 2011 and 2012 is difficult to reconcile with the strong employment growth (some 3-4% annually) during this period.

The programme only provides estimates of external balances for 2010, expecting that stronger domestic demand will only lead to a minor deterioration of the current account deficit, from -8% of GDP in 2009 to -9.4% in 2010.

Real sector

The programme contains an - ex-post – rather accurate assessment of the impact of the financial crisis on the country, expecting a drop in real GDP by only 0.6% in 2009, after 4.8% growth in 2008. The main drivers for this contraction were sharp drops in exports and investment. In 2010, output growth is projected at 2%, which will further accelerate to 3.5% in 2011 and to 5% in 2012. Exports are forecast to increase by some 13-14% in real terms in 2011 and 2012, while private consumption will grow by 2.7% in 2010 and 4% and 6% thereafter, benefitting from the strong increases of both employment and real wages. Private investment is forecast to benefit from improvements in the business environment and a surge of foreign investment.

In view of current assessments of the global outlook in the next few years, the underlying macroeconomic scenario appears plausible for 2010, but slightly optimistic for 2011 and 2012.

Inflation

After rather high inflation in 2008, price pressures declined markedly in 2009, reflecting lower import prices, notably a drop in food prices which had increased markedly the year before. Overall, average inflation was slightly negative in 2009. For the programme period, the PEP expects inflation rates between 2% - 2½%, which appears to be on the low side, considering the programme's expected strong increase in nominal wages by some 7%-8% annually and in domestic demand and potential increases in world commodity prices as the recovery sets in.

Monetary and exchange rate policy

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

External sector

The programme's external assumptions envisage a moderate recovery of the country's main export markets in 2010, which is in line with the current view of most international institutions. However, for the period 2011 and 2012, the programme is rather optimistic, as real exports are forecast to increase by 13%-14 %, while imports would increase by 14%-15%, annually. As a result, the trade deficit is expected to increase from 23% of GDP in 2009 to 25% in 2010. At the same time, current transfers are forecast to increase from 16.3% of GDP in 2009 to 16.5% in 2010. Overall, the current account deficit is expected to increase, from 8% in 2009 to 9.4% in 2010. Unfortunately the programme does not provide forecasts on the country's expected external balances beyond 2010. However, projected export and import flows suggest a significant deterioration of the trade balance, which most likely would also translate into a deterioration of the current account, unless strong assumptions are made on the expected increase of inflows of income and transfers. FDI inflows are projected to increase from 2.3% in 2009 to 4% in 2010.

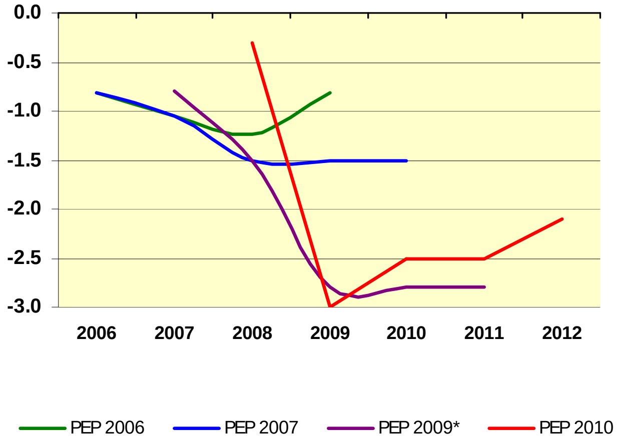
Overall, the expected moderate widening of the country's current account balance in 2010 is not in line with the programme's scenario of a strong domestic demand driven recovery. Assumptions concerning a significant increase of FDI inflows might be on the optimistic side, given the general expectation of a rather moderate recovery in the country's main partners and increased risk awareness of international investors.

Given the absence of projections for 2011 and 2012, it is difficult to assess the plausibility and sustainability of the programmes' external dimension. However, the programmes' scenario of low productivity growth combined with strong wage increases, points to a significant risk of a further deterioration of the country's competitiveness, which would translate into increasing external imbalances. This would have a negative impact on foreign exchange reserves, and the country's international financial position and could create pressure on the exchange rate.

2.5. PUBLIC FINANCE

The fiscal framework claims to support the economic recovery and envisages a decline in the public sector deficit from 2.7% of GDP in 2009, to 2.5% in 2010 and 2011 and to 2% of GDP in 2012. Total revenues are expected to increase in 2010 by 2½ percentage points of GDP, while the government's approach of lowering the tax burden will bring back the tax ratio by 2012 to the 2009 level. Expenditures are envisaged to increase by 2¼% of GDP in 2010 and to drop by 2012 about a ½ percentage point below the 2009 level. Thus, over the programme period, total revenues are planed to increase by about ¼ percentage point of GDP, while expenditure will be reduced by about ½ percentage point of GDP. Interest expenditure is expected to increase slightly, from 0.6% of GDP in 2009 to 1% of GDP in 2012.

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



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

The former Yugoslav Republic of Macedonia has a track record of over-performing or at least achieving its fiscal targets. In the past, this performance benefitted from strong economic growth and improved efficiency of tax collection. However, another important reason for the country's favourable fiscal performance has been the administration's weakness in implementing spending plans, in particular with respect to capital spending, leading to a very low level of public investment.

Like in the past, the programme is very parsimonious when it comes to quantifying the various planned revenue and expenditure measures. The programme expects economic growth to return to its potential growth rate by 2012.

Like last year, assessing the fiscal strategy is impeded by data inconsistencies, both between the descriptive part and the annex tables but also within the annex tables. The main element of the fiscal strategy seems to be a sharp increase in capital expenditure in 2010, while in 2010 and 2011 lower spending for public consumption and social transfers should compensate for the expected decline in revenues (from 36.7% of GDP in 2010 to 35.6% in 2011). The main source for financing the increased deficits will be foreign loans. As a result, the debt ratio is expected to increase by some 4½ percentage points of GDP, from 24.7% of GDP in 2009 to 27.9% in 2012, a still rather moderate level.

2.5.1. Budget implementation in 2009

In 2009, the public sector deficit increased from 1% of GDP in 2008 to 2.7%([6]). The increase in the deficit was mainly the result of a drop in revenues (by 5.8% compared to last year), while total spending was reduced by 0.6% only. On the revenue side, the biggest contribution for the decline came from indirect taxes, which accounted for some 43% of total revenues and declined by some 3% compared to 2008. Direct taxes, representing about 10% of total revenues, declined by some 23%.

([6]) The country's fiscal balances are still recorded on a cash base, leaving room for a certain extent of shifting payments either into the current year or postponing them into the next fiscal year. In the case of the former Yugoslav Republic of Macedonia, a more accrual based accounting probably would result in somewhat lower 2008 deficit (by maybe ¼ percentage point of GDP), and a higher 2009 deficit (by maybe up to ½ percentage point of GDP).

Social security contributions, accounting for some 30% of total revenues, increased by some 1.5%. The main reason for the increase in social security contributions was a reform of collection, while the contribution rates were actually lowered. On the expenditure side, spending for pensions and subsidies were increased by some 8%, while capital investment was reduced by some 10%. Public consumption declined by 0.8% in nominal terms.

Compared to the original budget adopted in December 2008, growth of both revenues and spending was about 11% lower than anticipated. On the revenue side, indirect taxes were expected to increase by 7%, while direct tax revenues were planned to increase by 14%. On the expenditure side, spending on social transfers and subsidies was actually higher than planned (in % of GDP), which was largely compensated by reducing capital spending: instead of increasing public investment to 5% of GDP, actual spending was close to previous realisations, i.e. at some 3% of GDP. In order to adjust spending to weaker than expected revenues, the government adopted two supplementary budgets: on 4 June, the first fiscal adjustment reduced planned spending by 9%, which implied an increase in spending compared to the realisation in 2008. On 7 September, parliament approved another supplementary budget, reducing planned spending by another 3%. According to preliminary data, actual spending in 2009, was about 1% lower than in 2008, or practically unchanged, when taking into account the drop in the overall price level by 0.8%. In both supplementary budgets, the main adjustment took place in the category of capital spending.

2.5.2. Near-term and medium-term budget strategy

The parliament adopted in December 2009 the central government budget for 2010, envisaging a fiscal deficit of 2.5% of GDP. The authorities expect real GDP growth of 2%, while inflation is projected to be 2%.

Revenues and expenditures are planned to increase by 3.4% and 2.8%, respectively. According to the programme, this will raise the share of total revenues and expenditures by more than 2 percentage points of GDP, to 36.7% of GDP and 39.2%, respectively. The revenue structure is expected to remain largely unchanged, with the main source of additional revenues being in the group of property income and other revenues. On the expenditure side, the share of most spending items is largely in line with previous years. However, the 2010 budget envisages an increase in subsidies by ¼% of GDP, and a rise of capital spending from 3% in 2009 to about 5% in 2010.

The budgetary target for 2010 is plausible, given the country's track record of achieving fiscal objectives. However, the impact of various measures on the performance of revenue and expenditures is presented in too general terms. The data presented are not very consistent, the mainly aggregated headline figures in the text appearing to differ from the more detailed tables in the annex. Like in previous programmes, the authorities expect a strong increase in revenues and expenditures, by some 2½% of GDP. Overall, the authorities' estimates may be rather on the optimistic side, both with respect to revenues, but also with respect to spending. However, in the past, the government tended to adopt optimistic budget proposals, but to adjust their estimates in a series of supplementary budgets during the course of the year, in order to align spending plans to the actual revenue performance.

In 2011 and 2012, the authorities envisage deficits of 2.5% of GDP and of 2.0%, respectively. During this period, total revenues are expected to decline by 2½% of GDP, while spending is planned to be reduced by 2¾% of GDP. Those reductions will be the result of increases in both revenues and spending below nominal GDP growth. In 2011, the authorities expect a significant deceleration in tax revenues, leading to a loss of revenues by about 1% of GDP, driven by a drop in indirect taxes and of social security contributions by about ½ % of GDP each. The drop in social security contributions results from a lowering of contribution rates, while the slowdown in direct tax revenues is not explained. On the expenditure side, social transfers will be lowered by about ¾ % of GDP through a better targeting of social beneficiaries. In 2012, total revenues are expected to drop by another 1% of

GDP, consisting of a further decline in revenues from social security contributions by ½% of GDP and a further reduction of other revenues. Expenditures are expected to decline by 1¾% of GDP, as a result of a drop of social transfers by nearly 1% of GDP, a reduction of public consumption by about ½% and a lowering of subsidies and gross fixed capital formation by nearly ¼%of GDP each. No further explanations are given.

Table II.2.3:

Composition of the budgetary adjustment (% of GDP) [1]

	2008	2009	2010	2011	2012	Change: 2009-12
Revenues	36.1	34.1	36.7	35.6	34.3	0.2
- Taxes and social security contributions	28.9	27.7	28.7	27.8	27.1	-0.6
- Other (residual)	7.2	6.4	8.0	7.8	7.2	0.8
Expenditure	36.4	37.1	39.2	38.1	36.4	-0.7
- Primary expenditure	35.7	36.5	38.3	37.2	35.4	-1.1
of which:						
Gross fixed capital formation	5.3	4.3	6.4	6.3	6.1	1.8
Consumption	14.2	13.7	13.6	13.5	13.0	-0.7
Transfers & subsidies	17.9	18.3	18.3	17.4	16.3	-2.0
Other (residual)	-1.7	0.2	0.0	0.0	0.0	-0.2
- Interest payments	0.7	0.6	0.9	0.9	1.0	0.4
Budget balance	-1.0	-2.8	-2.5	-2.5	-2.0	0.8
- Cyclically adjusted	-1.4	-1.5	-1.7	-1.9	-2.2	-0.7
Primary balance	-0.3	-2.2	-1.6	-1.6	-1.0	1.2
Gross debt level	21.3	24.7	26.5	27.1	27.9	3.2

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

[1] The data in the table reflects the country's data submission, where in some years revenues and expenditure do not add up to the reported budget balance.

2.5.3. Structural balance

The programme used a Hodrick-Prescott filter to calculate the country's potential growth. According to those calculations, potential growth is 3.1% during 1997-2012, with potential growth of 3.4% in 2008, dropping to 3.0% in 2009 and 2010 and recovering again to 3.2% and 3.4% in 2011 and 2012. In 2007 and 2008, actual growth was some 2-3 percentage points above potential, while in 2009 growth was clearly below potential. In 2010, growth will remain about 1 percentage point below potential, while in 2011 and 2012, expected growth is ¼ percentage point and 1¾ percentage points above potential. The authorities' calculations indicate a seasonally adjusted deficit of some 1½% of GDP in 2008, which however is increasing to more than 2% of GDP over the programme horizon. In 2008, the actual balance was about ¼ % of GDP lower than the seasonally adjusted balance, which however is rather small, given the significantly higher than potential realised growth. The realised deficit in 2009 and the planned deficit for 2010 are higher than the seasonally adjusted deficit, which is in line with expectations, given the clearly below potential growth in those 2 years. However, in 2011, the planned deficit is still about 1 % of GDP higher than the seasonally adjusted figure. Only in 2012, when expected growth will be 1¾ percentage points above potential, the planned deficit is slightly lower than the seasonally adjusted balance.

Given the country's growth performance during the last decade, an average growth potential of slightly above 3% appears to be on the cautious side. The programme's identification of historic periods with above potential and below potential growth is in line with Commission views. However, the presented information does not explain why the country should grow above potential in 2011 and in particular in 2012, when the difference between potential and planned growth is rather high. With respect to the policy stance, the fiscal deficit appears to have been slightly counter-cyclical in the recent past, with surpluses (albeit moderate) being observed in times of above potential growth.

However, in 2008, the fiscal stance appears to have become more neutral, with a fiscal swing from a surplus of 0.6% of GDP in 2007 to a deficit of 1% of GDP in 2008, despite above potential growth. According to those calculations, the policy stance became growth-supporting in 2009, with a marked increase in the deficit at times of below potential growth and will remain so until 2011. However, the expected increase in the structural deficit during the programme period to nearly 2½% will however erode fiscal space and over time reduce fiscal policy margins of manoeuvre. Unfortunately the programme does not contain information on one-off and temporary measures.

2.5.4. Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

According to the data submitted, the general government gross debt was 21.3% of GDP at the end of 2008 and increased further to 24.7% at the end of 2009.([7]) During the programme period, this ratio is expected to increase to 27.9% of GDP. The main factor behind the increase in 2009 is the primary balance, while GDP growth and inflation have no significant impact on the debt ratio. In 2010, the debt ratio will increase further, again mainly due to the combination of a primary deficit and rather low nominal GDP growth. In 2011 and 2012, the increase in the debt ratio is expected to slow down, partly due to a lower planned deficit, but to a large extent to stronger nominal GDP growth.

However, besides some rather general statements from the 2009-2011 debt strategy referring to some target ratios for the period 2009-2011, the document does not provide much detail on expected debt developments in 2010, or for the whole programme period. Furthermore, it does not mention any quantitative details neither on ongoing or planned privatisation projects nor other one-off measures.

Table II.2.4:

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

	2008	2009	2010	2011	2012
Gross debt ratio [1]	**21.3**	**24.7**	**26.5**	**27.1**	**27.9**
Change in the ratio	-3.4	3.4	1.8	0.6	0.8
Contributions [2]:					
1. Primary balance	**0.1**	**2.4**	**1.6**	**1.6**	**1.1**
2. "Snow-ball" effect	**-3.5**	**0.7**	**0.0**	**-0.5**	**-0.9**
Of which:					
Interest expenditure	0.7	0.6	0.9	0.9	1.0
Growth effect	-1.0	0.1	-0.5	-0.9	-1.3
Inflation effect	-3.2	0.0	-0.5	-0.5	-0.6
3. Stock-flow	**0.0**	**0.3**	**0.2**	**-0.5**	**0.6**

Notes:

[1] End of period.

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

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

In order to improve debt management, the Ministry of Finance established a central public debt management department in 2005 and adopted a medium-term public debt strategy, currently covering

([7]) Table 4 in the programme's data annex provides data on the consolidated general government sector, which is not in line with the ESA 95 concept. In particular, this definition does not to include debt of public enterprises, amounting to about 3% of GDP.

the years 2009-2011. Like previous strategies, this document envisages a limit to the increase in public debt ratio to 40% of GDP.

According to the programme, currently, about 97% of the total public debt is denominated in foreign currency, with a dominant share of the euro of about 67%. The average maturity of external public debt is relatively long (about 8½ years), and the implicit interest rate is rather low, which is related to the high share of IFIs in the debt portfolio. However, as the country moves closer towards a more mature economy, financial support from donors and multilateral institutions is likely to decrease, while financing costs at the private international market are substantially higher. In June 2009, the authorities issued a € 175 mio Eurobond, at an interest rate of 9.875% annually. Domestic debt has an average maturity of some 2¼ years only. Debt servicing costs are expected to remain at around 1% of GDP by 2012.

Overall, the debt ratio is rather low. However, the high share of foreign denominated debt exposes the country to a substantial exchange rate risk. Furthermore, financing costs of the debt are likely to increase substantially in the near term, given that the country intends to increasingly tap private capital markets. Compared to last year's programme, no significant changes in the country's debt policy are envisaged.

2.5.5. Budgetary implications of "major structural reforms"

Like last year, the document contains a detailed matrix of policy commitments, with quantitative information on the impact of various reform measures on budgetary expenditures and revenues. The presentation also contains information on the time schedule of the various measures. However, the presentation of planned structural measures appears to be less complete than last year. For example, the costs and benefits of the ongoing payroll reform would have deserved a more detailed discussion.

Like in the previous submissions, the presentation would have benefited from a more explicit description of the government's policy priorities and the policy mix which results from its priorities. The policy mix contains measures which are in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the European Partnership. However, when looking at the fiscal commitments, the policy mix appears to be increasingly focussed on promoting agriculture, while the financial commitments related to other policy objectives, such as direct measures to address the labour market imbalances and improving the efficiency of public administration, have been further reduced. According to the provided data, the level of fiscal commitments for structural reforms will drop from some 4.6% of GDP in last year's programme, to less than 2.9% in 2010 and to around 2% in 2011 and 2012. Spending commitments for the agricultural sector amount to some 60% of total commitments in 2010 and increase further to some 80% of total commitments in the remaining programme period. In 2010, another 30% of commitments are devoted to infrastructure, while allocations for labour market policy are only some 5% of total allocations (or 0.2% of GDP).

Overall, in terms of fiscal support, the authorities' reform priorities appear to have further moved towards promoting agriculture, while accession related reform challenges, such as addressing labour market or institutional issues, appear to be considered as a lower priority.

2.5.6. Sensitivity analysis and comparison with previous PEP

Like last year, the programme presents an analysis of the impact of various alternative scenarios on the budget deficit. The first assumes real GDP to grow only at half of the baseline rate, a second scenario looks at the implications of revenue growth of only ½ of the baseline scenario and the third scenario calculated the impact of a doubling of growth of expenditure. In all three cases, the initial impact on the fiscal deficit is about 1% of GDP. In the low growth scenario the deficit deteriorates by another 1½ percentage point of GDP in 2010, to 4% of GDP and remains on this level for the remaining programme period. In the case of the revenue-shortfall scenario and the expenditure shock scenario the overall deficit remains rather stable between 2 ½ -3% of GDP during 2010 and 2011, and improves by about ½ percentage point in 2012. Given the currently high uncertainty related to the global growth environment and the strong impact of lower growth on the deficit, it would have been useful to present contingency measures for the case of fiscal slippage.

2.5.7. Quality of public finances and institutional features

During recent years the country embarked on a number of public administration reforms, which – with support from the IFIs – intended to improve the transparency and efficiency of public administration in general. Another impulse for public sector reform is based on the Ohrid framework agreement from 2001. In line with this agreement, the authorities are in the process of implementing a programme of administrative decentralisation, which envisages transferring to the local communities' competences and financial means in a number of areas (such as education, health, local cultural institutions, urban planning and construction, fire brigades, etc.). So far, mainly the responsibilities have been transferred, while financial competences still remain to a large extent with the central government. Overall, recent measures, such as the reform of the Public Revenue Office, have helped to improve the public administration's efficiency.

The consistently high differences between revenue and expenditure estimates and the frequent adoption of supplementary budgets points to a rather limited capacity in fiscal planning. So far, the actual planning horizon appears to be shorter than the fiscal year and fiscal measures are often taken on an ad-hoc base and without proper discussion in parliament, nor with the broad business community, nor the civil society. As far as the revenue structure is concerned, published data point to a rather high share of direct taxes, amounting to about one third of total revenues. Furthermore, direct taxes are planned to rise as a share in GDP, which is in contrast to the government's official policy on direct taxation. Social contributions are the second most important source of revenues, accounting for about ¼ of total revenues. The programme plans to reduce social contribution rates further over 2010-2012. However, the document does not assess the impact of those measures on the fiscal sustainability of the social security institutions. On the expenditure side, transfers and public consumption account for some 40% of spending. Like in the past, the programme plans to substantially increase capital spending, from some 14% of total spending in 2008 to 17% in 2012. This increase would represent an important improvement in the country's public spending structure.

2.5.6. Sustainability of public finances

The programme presents as requested long-term estimates on the sustainability of public finances for the period 2000-2050. The scenario envisages stronger growth (increasing from 2% in 2010 to 5.6% in 2020 and decelerating to 4% in 2050) and a decline in unemployment (from 30.8% in 2010 to 11.5% by 2050). Revenues and expenditures are expected to rise again after their projected drop in 2012 and to reach a constant level of some 36% and 38% of GDP during 2020-2050, implying a constant fiscal deficit of 2% of GDP over the period. Expenditures for pensions are expected to increase sharply form 5.3% of GDP in 2005 to 8.5% in 2010, but to stabilise at 8% of GDP during the remaining period. Health expenditures are set to decline, from 5.5% of GDP in 2005 to 4.2% in 2050. Spending for education is projected to increase, from 4.9% of GDP in 2005 to 5.8% in 2050.

Overall, there appear to be no major and immediate threats to the long-term sustainability of the country's public finances, in particular in view of the country's relatively low debt level. Demographic pressures seem to pose no major threats, although a continued reform of the social security system appears to be necessary to keep public sector health spending under control. Provided that the current public sector reform agenda is fully implemented, the former Yugoslav Republic of Macedonia seems to be relatively well placed to meet the costs of an aging population. Nevertheless, costs in relation to the reform of the pension and health-care systems should be monitored carefully.

2.6. STRUCTURAL REFORMS

Like last year, the 2010 PEP provides a broad overview of the country's structural reform agenda. The document also contains a matrix of policy commitments, with quantitative information on the impact of the various reform measures on budgetary expenditures and revenues. This matrix also includes information on the time schedule of the various measures. However, as in the past, the presentation would have benefited from a more explicit discussion of the government's policy priorities and the policy mix which results from its priorities. The policy mix appears to focus on a few areas, such as agriculture and infrastructure, while only very limited means appear to have been committed to policy areas in line with the Lisbon agenda and the priorities derived from the Commission's Progress Report and spelled out as economic priorities in the European Partnership.

Compared to last year's submission, the level of fiscal commitments for structural reforms has been reduced, from 4.6% of GDP in 2009 in last year's programme to around 2.9% of GDP in 2010 in this year's submission. This profile is surprising, given the expected sharp acceleration in GDP growth towards the end of the programme period.

Table II.2.5:
Net direct budgetary impact of key reform commitments (in EUR million)

	2010	2011	2012
Agriculture and rural sector	109.8	120.7	132.8
Railway infrastructure and introduction of system for	62.1	5.9	6.5
Labour market reforms	10.9	12.0	13.2
Other reforms (public administration, knowledge-based society, judiciary, envrionment, public procurement etc)	6.0	5.8	6.4
Total impact on the budget	188.8	144.3	158.8
Total impact on the budget (in % of GDP)	2.9	2.1	2.2

Source: 2010 Pre-accession Economic Programme (PEP), ECFIN calculations

2.6.1. Product and capital markets

Like in previous submission, the 2010 programme contains a detailed description of a large number of structural reform areas targeted to improve the efficiency of product and capital markets. The main reform areas mentioned in the document are the support of the agricultural sector, the improvement of the infrastructure, the strengthening of the industrial sector's competitiveness and of competition policy and state aid control, the improvement of business environment, increased support for SMEs and the liberalisation of network industries (energy, telecommunication, transport,…). However, compared to last year's programme, the 2010 PEP provides less and incomplete information on budgetary allocations for the various reform areas. However, the focus appears to be on agriculture and infrastructure.

Overall, the pace of structural reforms appears to be relatively moderate in the programme, which allocates a limited amount of budgetary resources to promote structural reforms. Furthermore, a considerable share of the available funds seems to be devoted to areas which in view of meeting the Copenhagen criteria might not be the most effective ones, such as agriculture, while improved funding for addressing education and labour market rigidities might have been more in line with accession related priorities. With respect to the timing of reforms, the programme presents a front-loaded approach with respect to improving infrastructure, while the support for agriculture is spread more evenly over the programme period. However, the reliability of the presented quantitative information appears to be rather low.

With respect to the reform of capital markets, the programme envisages a further alignment with the EU acquis, further steps in implementing Basle II and a further strengthening of the regulatory and supervisory institutions. In contrast to the product market reforms, the information provided in this respect is more concrete and operational.

2.6.2. Labour market

The document contains information on recent labour market reforms and in particular on administrative measures, but however, like in the previous programme, information on policy objectives and intended fiscal commitments for the remaining programme period in very limited.

2.6.3. Other reform areas

The 2010 programme presents a significant number of other reform projects, related to the judiciary system, to social security, rural development, infrastructure, to public administration, trade liberalisation etc. Overall, like last year, the presentations tend to devote much emphasis on past developments and often remain relatively vague with respect to concrete plans for the programme period. Like in the other reform areas, the conceptual link to the EU accession process, notably the European Partnership, is rather limited.

2.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework. The programme presents a clear picture of past economic developments. However, the macroeconomic scenario appears to be based on data for the first half of 2009 only, while at the time of the finalisation of the submission more recent data would have been available. Overall, the macro framework is sufficiently comprehensive.

Fiscal framework. The fiscal framework is largely in line with the macroeconomic framework and takes into account accession related priorities. However, the document provides very little and usually only very general information on intended measures and their fiscal implications. There are numerous cases of basic inconsistencies within the provided tables. The data are not in line with ESA 95 and there is no indication of a timeframe for better aligning fiscal statistics with ESA 95 standards. Consistency with the latest reporting in the fiscal notification is limited.

Structural reforms. The presentation of structural reforms contains a broad range of numerous measures. However, the provided information is focussing on legal aspects and there is hardly any reference to policy priorities, nor to accession related issues.

Table II.2.6:

Annex: Structural indicators

	The former Yugoslav Republic of Macedonia					EU 27				
	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
General economic background										
Real GDP [1]	4.1	4.0	5.9	4.9	-2.0	2.0	3.2	2.9	0.8	-4.2
Labour productivity [2]	54.4	55.1	56.4	58.0	59.9	100	100	100	100	100
Real unit labour cost [3]	-8.6	6.2	-12.9	-4.2	-0.7	-0.6	-1.2	-0.6	0.5	2.2f
Real effective exchange rate [4]	n.a.	n.a.	n.a.	n.a.	n.a.	107.5	106.4	107.9	114.0	n.a.
Inflation rate [5]	0.5	3.2	2.3	8.3	-0.8	2.2	2.2	2.3	3.7	1.0
Unemployment rate [6]	37.3	36.0	34.9	33.8	32.2	8.9	8.2	7.1	7.0	8.9
Employment										
Employment rate [7]	34.1	39.6	40.7	41.9	n.a.	63.5	64.5	65.4	65.9	n.a.
Employment rate - females [8]	25.4	30.7	32.3	32.9	n.a.	56.3	57.3	58.3	59.1	n.a.
Employment rate of older workers [9]	23.2	27.9	28.8	31.7	n.a.	42.3	43.5	44.6	45.6	n.a.
Long term unemployment [10]	n.a.	n.a.	n.a.	n.a.	n.a.	4.1	3.7	3.1	2.6	n.a.
Product market reforms										
Comparative price levels [11]	43.2	44.5	43.9	46.9	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	n.a.	n.a.	n.a.	n.a.	n.a.	9.8	10.7	10.8	11.4	n.a.
Net FDI [13]	1.6	6.8	8.8	6.3	3.7e	1.7	2.3	3.8	2.2	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	0.5	n.a.	n.a.
Business investment [16]	3.0	4.0	n.a.	n.a.	n.a.	17.7	18.2	18.7	18.4	n.a.
Knowledge based economy										
Tertiary graduates [17]	4.0	4.3	4.6	n.a.	n.a.	13.2	13.0	n.a.	n.a.	n.a.
Spending on human resources [18]	n.a.	n.a.	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	n.a.	75.8	79.2	79.7	n.a.	77.5	77.9	78.1	78.5	n.a.
R&D expenditure [20]	n.a.	n.a.	n.a.	n.a.	n.a.	1.8	1.9	1.9	1.9	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

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

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

Source: Commission services, national sources

3. TURKEY

3.1. EXECUTIVE SUMMARY

Turkey's ninth Pre-accession Economic Programme (PEP 2010-2012) was submitted to the Commission in mid-February 2010. It presents a largely realistic and comprehensive medium-term macroeconomic framework. The programme's overarching objectives are largely appropriate, as they aim at minimising the negative effects of the global crisis and at returning to a stable macro economic path conducive to growth and employment, building on Turkey's economic and social strengths. The document largely complies with the content, form and data requirements, and is highly consistent with earlier key policy documents, as it was prepared on the basis of the Medium-Term Economic Programme and the 2010 budget. The PEP is a useful tool for economic policy making, and adequately explains and quantifies its objectives.

The Turkish economy contracted by 4.7% in the year to 2009, after rising by 0.7% in 2008. This decline was largely driven by constrained domestic bank lending, limited foreign capital inflows and weak external demand. The pace of the contraction gradually started to level off since the second quarter of the year due to the impact of fiscal stimulus, large interest-rate cuts and a recent return of global risk appetite. Fiscal stimulus measures, in tandem with the lower tax revenues caused by the economic slowdown, led to a widening of the general government deficit from 1.6% of GDP in 2008 to 5.5% of GDP in 2009 and to a parallel rise in public debt to 46% of GDP in 2009. While consumer price inflation fell to 6.5% in December 2009, well below the 7.5% official year-end target, inflationary pressures, mainly driven by higher food prices, have steadily risen since October. Labour market imbalances have built up, and the unemployment rate increased by roughly one third, from 11% in 2008 to 14% in 2009. The challenges related to inflation, growth and employment are duly taken into consideration in the programme which adequately addresses most of the economic priorities of the Accession Partnership and the key challenges spelled out in the 2009 Progress Report.

The macroeconomic scenario, which underpins the PEP, adequately underlines that a comprehensive structural reform programme must be implemented to sustain the competitiveness of the economy, growth and fiscal stability. The overall macro economic framework for 2010-2012 seems plausible. The PEP projects an acceleration of real growth to 3.5% in 2010, forecast to accelerate to 4% in 2011 and 5% in 2012 under the assumption of a gradual recovery of the world economy. In 2010, all domestic demand components are strengthening, but in particular gross fixed capital formation that would increase by 7.6%. As could be expected, external imbalances are projected to start rising along with the economic recovery while labour markets react marginally, and with some delay to higher growth. Some doubts might however be raised as regards price developments which appear somewhat conservative. Inflation could be expected to head higher in 2010, and likely beyond the PEP's expectations, notably since sizeable increases in the tax arrears of state-owned energy enterprises may require further utility price hikes this year.

A key policy challenge at this juncture appears to be the consolidation of public finances. The fiscal programme envisages an improvement of the consolidated general government balance, from a projected deficit of 6.6% of GDP in 2009 to a 4.7% deficit in 2010, 3.5% in 2011 and 2.7% in 2012, largely in line with the growth scenario. The sizeable fiscal relaxation implemented in 2009 in the context of the economic crisis and the upcoming elections in 2011, combined with the adoption of a strong fiscal rule only by 2011, may lead to an actual fiscal outcome much less favourable than projected in the programme. Consolidation will be essential to macro-economic stability and coupled with productivity enhancing structural reforms could play a key role in the narrowing of the country's savings-investment gap and in reducing the present heavy reliance on foreign savings.

The programme's structural and institutional reform agenda is largely adequate, and aims at sustaining the dynamics of structural reforms by increasing competitiveness, strengthening the functions of regulatory agencies, and addressing labour market imbalances. The impact of the various reforms appears to be better analysed and quantified than in previous years. The operations foreseen in 2009 have been largely implemented. An ambitious reform agenda, aiming at improving the investment climate, aligning competition policy with EU standards and strengthening the financial, agricultural and energy sectors is scheduled for 2010-2012.

Turkey's overall policy response to the financial crisis has been broadly appropriate, timely and targeted. Temporary fiscal stimuli measures are being phased out, according to plans. Main risks to the macroeconomic framework are associated with the effects of a possible prolongation of the global crisis on Turkey's major EU trading partners and thus on the domestic economy and financial sector. Risks are somewhat elevated due to the large debt service obligations coming due in the coming years, particularly in the corporate sector.

The programme's reform agenda is well integrated and consistent with the fiscal scenario and largely aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership. The programme puts strong emphasis on harmonisation with EU requirements but provides concrete information only on past and ongoing reform initiatives.

Table II.3.1:

Comparison of key macroeconomic and budgetary projections

		2008	2009	2010	2011	2012
Real GDP growth (% change)	COM	0.9	-5.8	2.8	3.6	n.a.
	PEP 2010	**0.9**	**-6.0**	**3.5**	**4.0**	**5.0**
Consumer price inflation (%)	COM	10.4	6.1	5.6	5.5	n.a.
	PEP 2010	**10.4**	**6.3**	**6.4**	**5.9**	**5.3**
General government balance (% of GDP)	COM	-2.2	-7.9	-6.8	-5.8	n.a.
	PEP 2010	**-1.6**	**-6.6**	**-4.7**	**-3.5**	**-2.7**
Primary balance (% of GDP)	COM	2.9	-2.5	-1.5	-0.6	n.a.
	PEP 2010	**3.9**	**-0.2**	**1.3**	**1.7**	**2.1**
Government gross debt (% of GDP)	COM	39.5	47.3	49.8	51.0	n.a.
	PEP 2010	**39.5**	**47.3**	**49.0**	**48.8**	**47.8**

Sources: Pre-Accession Economic Programme (PEP), Commission autumn 2009 forecast

3.2. INTRODUCTION

Turkey submitted its ninth PEP in mid-February 2010, covering the period 2010-2012. The programme has been adopted by the High Economic Council, which comprises all key parts of the government. It is a joint document with contributions of a large number of line ministries and the Central Bank, under the coordination of the State Planning Organisation. Social Partners were not involved in the preparation of the document. The programme is an update of the previous PEP. It is prepared on the basis of the Medium Term Economic Programme (presented in September 2009), and takes the 2010 budget, as well as the national development plan into account. The link to the country's accession process, such as the European Partnership priorities and the Commission's assessment in the Progress Report appears stronger than in previous years. The document largely complies with the content, form and data required for this exercise. It contains a general overview of recent economic developments and presents a largely consistent macroeconomic framework. It benefits from several alternative scenarios and assessments of their fiscal impact.

The document describes the key medium-term fiscal and other policy objectives and provides a detailed presentation of structural reforms of product and capital markets. The document includes the quantitative information required. However, its completeness and consistency may still benefit from the ongoing statistical improvements. In particular the fiscal data need to be brought better in line with the ESA95 requirements.

3.3. KEY CHALLENGES

Under the current circumstances, Turkey has to mitigate the impact of the global financial crisis and maintain the sustainability of the country's external balances while using the fiscal and monetary policy mix in an efficient and prudent way. Addressing labour market imbalances, in particular in the youth and female segments, remains another important medium-term issue. The authorities need to avoid a fiscal relaxation that would put at risk the macro-economic stability achieved so far or would weaken the long-term growth-potential of the economy. Fiscal consolidation and structural reforms should play a key role in the narrowing of the country's savings-investment gap and in reducing the heavy reliance on foreign savings. A continuation of a prudent monetary policy aimed at stabilising the exchange rate and containing inflationary pressures seems essential to anchor market expectations under more severe external financing constraints and to preserve financial sector stability.

3.4. RECENT ECONOMIC DEVELOPMENTS AND MEDIUM-TERM SCENARIO

3.4.1. Recent macroeconomic developments

GDP fell by about 4.7% in 2009, a sharp contrast from the 6% average annual growth rate from 2004-08. The global financial crisis hit the economy hard, slowing capital inflows and reducing external demand. Fiscal and monetary stimuli, combined with a healthy banking sector, helped cushion the contraction. In Turkey’s case, the crisis highlighted the economy’s enhanced resilience to external shocks. The crisis particularly affected net exports and investment flows, while private and public consumption remained rather resilient. In tandem with the sharp fall in gross fixed capital formation by 17.7% (PEP) and - albeit to a lesser extent - exports, imports dropped significantly. This resulted in a significant reduction in the trade deficit, from 7.2% of GDP in 2008 to 4% in 2009. The deficit in the income balance rose by about one third, from 1.1% of GDP to 1.4% of GDP. In large part, thanks to a relatively well performing touristic sector, the surplus on the service balance increased from 2.3% of GDP in 2008 to 2.8% in 2009. In sum, the current account deficit narrowed from 5.7 of GDP in 2008 to some 2.2% in 2009. Fiscal stimulus measures, in tandem with lower tax revenues in line with the economic slowdown, led to the widening of the general government deficit from 1.6% of GDP in 2008 to 5.5% of GDP in 2009. Public debt rose in parallel by over 8 percentage points to 47% of GDP in 2009. Consumer price inflation fell from 8.1% y-o-y at the end of 2008 to 6.5% in December 2009, well below the 7.5% official year-end target. Labour market imbalances have built up, and the unemployment rate increased by roughly one third, from 11% in 2008 to 14% in 2009. In spite of some targeted new measures, female and youth employment remain particularly low.

Box II.3.1: The global financial crisis: Impact and policy response

The global financial crisis and the marked slowdown in Turkey's main trading partners has adversely affected the Turkish economy. The Turkish financial sector weathered the crisis relatively well, benefitting from a strong financial base with very little impaired assets, and major regulatory and supervisory improvements made in the aftermath of the 2001 financial crisis. The real economy was hit relatively hard, and the authorities made major adjustments to the policy mix.

Monetary Policy

The central bank cut base lending rates by a cumulative 1025 points in the year to November 2009. The strong easing was justified by the economic slowdown, and the decline in inflation, and yield curves reacted remarkably well. Since November 2009, however, inflationary pressures have risen significantly. Besides, the central bank took measures to increase the FX liquidity on the inter-bank market and occasionally sold USD via auctions (which amounted in total to a mere USD 900 million in 2009) to prevent excess exchange rate volatility.

Fiscal Policy

The government has adopted several stimulus packages, which in total amount to 6.6% of GDP. In 2009, measures worth 3.4% have been implemented. Guarantee, insurance and lending schemes have been established to support exporters and SMEs. The financial support to these sectors has been phased out in 2009 and amounted to about 1.2% of GDP. Major other packages included the reduction of a special consumption tax for motor vehicles - which also expired in late 2009, subsidies provided to consumer lending, public investment in infrastructure, subsidies to employers' social security contributions, hikes in public sector salaries, and transfers to the local authorities. In 2010, further measures, amounting to 2.2% of GDP are scheduled. Major spending increases aim at higher pensions, providing more resources to the local authorities, propping up the textile sector and stimulating consumer lending.

The government's anti-crisis measures are likely to have positively affected the country's economic performance in 2009. Some of them have already been timely exited. However, the measures scheduled in 2010, one year before elections take place, comprise a larger share of current spending which may endanger the quality of the public finances and Turkey's long-term growth potential. In addition, some of the measures, notably the hikes in civil servant salaries and pensions do not appear to be temporary or well targeted.

Table II.3.2:

Comparison of macroeconomic developments and forecasts

	2008		2009		2010		2011		2012	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	0.9	**0.9**	-5.8	**-6.0**	2.8	**3.5**	3.6	**4.0**	n.a.	**5.0**
Contributions:										
- Final domestic demand	-1.1	**-1.1**	-7.6	**-6.1**	2.4	**3.7**	4.1	**4.2**	n.a.	**5.9**
- Change in inventories	0.3	**0.3**	-1.2	**-1.7**	1.2	**0.2**	0.2	**0.3**	n.a.	**0.0**
- External balance of goods and services	1.7	**1.7**	3.1	**1.8**	-0.7	**-0.4**	-0.7	**-0.5**	n.a.	**-0.9**
Employment (% change)	2.2	**2.2**	-1.3	**-0.6**	0.9	**1.3**	1.4	**1.9**	n.a.	**2.6**
Unemployment rate (%)	9.8	**11.0**	13.5	**14.5**	13.9	**14.3**	13.5	**14.1**	n.a.	**13.3**
GDP deflator (% change)	11.7	**11.7**	5.6	**6.0**	5.8	**5.0**	5.3	**4.5**	n.a.	**4.5**
CPI inflation (%)	10.4	**10.4**	6.1	**6.3**	5.6	**6.4**	5.5	**5.9**	n.a.	**5.3**
Current account balance (% of GDP)	-5.7	**-5.7**	-2.1	**-1.8**	-2.8	**-2.8**	-3.6	**-3.3**	n.a.	**-3.9**

Sources: Pre-Accession Economic Programme (PEP); Commission Autumn 2009 forecasts (COM)

3.4.2. Medium-term macroeconomic scenario

The PEP 2010-2012 presents a comprehensive medium-term macroeconomic scenario with projections for key economic variables, covering the real sector, employment, wages, inflation as well as external developments. The growth projections have been revised from last year's PEP scenario, taking into account the effects of the crisis on the external environment, albeit only up to November 2009. The external assumptions of the PEP 2010-2012 have thus markedly changed. For 2010 and 2011, the programme assumes euro area real growth rates of 0.3% and 1.5%, respectively. There is neither an assumption for world trade growth in 2011-2012, nor for euro area GDP growth in 2012 in the programme. In 2011, the volume of world imports is assumed to rise by 2.5%. Oil prices in 2010-2012 are projected to rise from USD 75 to USD 80 per barrel. All of these assumptions appeared plausible by the end of 2009.

The macroeconomic scenario appears broadly realistic. However, the projections of real GDP growth in 2010-2012 may be on the optimistic side and are surrounded by significant risks even though consensus has risen on the fact that the economy is off to a stronger start than earlier anticipated. Alternative scenarios have not been elaborated and some assumptions appear as somewhat outdated or are lacking.

Real sector

The PEP projects an acceleration of real growth to 3.5% in 2010, strongly up from a contraction of 6.0% in 2009. Growth is forecast to accelerate to 4% in 2011 and 5% in 2012 under the assumption of a gradual recovery of the world economy. The recovery in 2010 is the result of a strengthening of all domestic demand components, but more particularly of gross fixed capital formation that would increase by 7.6% in 2010. This rise would primarily stem from a significant increase in corporate sector investments, in tandem with a surge in FDI, better external financing conditions and stronger business confidence. Private consumption growth is projected to accelerate to 2.6%, while public consumption growth is expected to increase by 2.4% in 2010. Apart from strong base effects, the increase in domestic demand also results from the announced fiscal stimulus, combining some large infrastructure projects with an increase in current public spending which is scheduled to take place in 2010. The growth of exports of goods and services is expected to rise significantly faster, at 4.2%, than the projected increase in world import volumes, which is set at 2.5% in the PEP. The contribution of net exports to growth is projected to turn negative in 2010 and beyond, as the volume of total imports will rise faster than total exports. For 2011 and 2012, the PEP projects a strengthening of the economy, supported by an improved business climate and a continuation of productivity enhancing structural reforms. Private consumption growth is expected to accelerate to 3.3% in 2011 and 4.8%, in 2012. Gross fixed capital formation is expected to recover rapidly and grow by double digit levels by 2012.

Overall, there are major uncertainties surrounding the PEP's growth projections for 2010. Recent developments in the external environment, in particular regarding trade, oil prices and domestic inflation developments do not entirely square with the PEP’s underlying assumptions. Moreover, the crowding-out of domestic private sector investment by the public sector may limit the scope for the anticipated very strong recovery of corporate sector investment. At the same time, the increase in private consumption growth could be much more subdued in 2010, resulting from lower employment and disposable income, negative wealth effects from asset price adjustments, and weak consumer confidence in a situation of high uncertainty. Alternative scenarios would have been helpful, in particular since the PEP projections are subject to many upside and downside risks. Indeed, the more recent developments point at a gradual recovery, albeit at a variable pace, with Turkey recovering faster than most other European economies. However, the assumptions underlying the growth recovery over 2010-2012 may still be somewhat optimistic. Actual growth would be 1-2% higher than potential output as calculated in the PEP throughout 2010-2012. This seems to be rather unlikely, as persistent growth rates above potential growth may require a longer than envisaged adjustment period. A full implementation of the programme’s fiscal and structural policy agenda without delays is a critical condition for achieving a robust recovery.

On labour market developments, the PEP projects employment growth to rise by 1.3% in 2010, up from a 0.6% decrease in 2009, and to slightly accelerate to 1.9% and 2.6% respectively in 2011 and 2012. The unemployment rate (ILO) will start to fall gradually as from its 14.5% peak in 2009 to 13.3% at the end of the PEP horizon. The programme may nevertheless overestimate the positive effects of growth on labour market dynamics, in particular in view of the still significant inflows of an annual 1.5% of population in the Turkish labour markets and of the significant time lag taken by labour developments to follow the business cycle.

Inflation

Consumer price inflation ended 2009 at 6.5% y-o-y, well below the 7.5% official target. The PEP, however, projects inflation to stabilize in 2010, at 6.4%, before falling to 5.9% and 5.3% in respectively 2011 and 2012. The PEP projection is based on a stable exchange rate of the TRL in real effective terms against the euro, lower food and energy prices on world markets than at the time of submission, and a significant acceleration of domestic demand. The PEP assumes that cost push pressures will remain limited as the growth of unit labour costs will be subdued.

The inflation outlook of the programme appears conservative and it is very likely that inflation will overshoot the Central Bank 6.5% target at the end of 2010. In its February 2010 inflation report, the central bank acknowledges that inflation will rise in the forthcoming period due to base effects and recent tax hikes, which in turn is an important risk factor through its potential impact on inflation expectations. Risks are significant. Inflation has already steadily risen since hitting a 39-year low of 5.1% in October 2009. Annual CPI in February 2010 rose by a faster-than-expected 10.1%, well above the 8.2% rise seen in January, mainly due to strong pressures on food prices. In addition, the already higher than projected prices for imported raw materials are likely to translate into higher inflation. Domestically, stronger inflationary pressures could result from stronger wage increases, if public sector pay increases cannot be contained and spill over to the private sector. Moreover, necessary alignments of indirect taxes (e.g. excises) as well as further adjustments of administrative prices could add to prices increases. At the same time it is reasonable to assume that a continuation of the stability-oriented monetary policy framework will help preventing a significant re-acceleration of inflation in the medium-term.

Monetary and exchange rate policy

The present policy framework, which has been in place for several years, is labelled as an inflation targeting floating exchange rate regime. The primary policy objective is price stability, and the exchange rate has recently successfully been used as a stabilisation device, conducive to anchoring inflationary expectations. The PEP rightly argues that the choice for such a regime is largely determined by the fact that the structural transformation in the Turkish economy, the convergence process and the pricing behaviour inherited from the high inflation period warrant a gradual path towards price stability. As the main policy instrument, short term interest rates will be primarily determined by considering the medium term inflation outlook as before. Furthermore, the Central Bank may use instruments such as required reserve ratios or effective liquidity management if necessary. Turkey is a relatively open economy where the euro is widely used for trade invoicing and the dollar still prevails in debt holding. The latter could imply significant risks due to balance sheets mismatches of the private corporate and non-corporate sector. Under these conditions, the avoidance of too high volatility becomes an objective in itself to safeguard financial sector and macroeconomic stability.

External sector

The PEP projects a marked, albeit gradual, increase of the current account deficit in 2009, from 1.8% of GDP in 2009 to 3.9% in 2012. These assumptions appear plausible. Although the growth of exports will be significantly affected by a gradually rising demand of Turkey's main trading partners, the expansion in total imports is likely to have a much larger impact on the current account, due to the combined effect of higher prices for energy and commodities and a more significant acceleration of domestic investment and consumption than in most other countries. On the financing side, the PEP scenario is fairly conservative in projecting capital inflows and the stock of foreign reserves to rise by 3-4% annually until 2012, especially if the recent good performance of Turkey in attracting capital inflows is taken into account.

Main risks

The main risks to the macroeconomic framework are clearly associated with the effects of a possible prolongation of the global crisis on Turkey's real economy and financial sector. A slower recovery in the major EU trading partners will certainly affect prospects for growth. Risks are somewhat elevated due to the large debt service obligations coming due in the coming years, particularly in the corporate sector. The programme benefits from an in-depth assessment of those issues, whereby it concludes that Turkey’s non-banking sector holds a substantial open foreign exchange position, albeit significantly smaller than in previous years. It remains therefore sensitive to external shocks, particularly exchange rate fluctuations. However, according to the programme, the concentration of these FX liabilities in large-scale and/or exporting firms with relatively sound balance sheets reduces default risk. Moreover, the fact that about one-third of non-bank firms’ external debt has been borrowed from foreign branches of domestic commercial banks also needs to be considered.

3.5. PUBLIC FINANCE

The fiscal framework of the PEP 2010-2012 is presented as an integral part of - and supportive to - the overall medium-term economic policy framework, which aims at maintaining debt levels below 50% of GDP, enabling sustainable growth, reducing unemployment and increasing employment levels. The general direction of continued fiscal adjustment to ensure the long-term sustainability of public finances remains unchanged and broadly appropriate in view of the higher crisis-related public spending and still significant external vulnerabilities. However, fiscal targets are less ambitious compared to last year's PEP. The sizeable fiscal relaxation implemented in 2009 in the context of the economic crisis and the upcoming elections in 2011, combined with the suggested approach of adopting a fiscal rule by 2011 only, may lead to an actual fiscal outcome much less favourable than projected in the programme. The revenue projections for 2010 appeared as somewhat optimistic given the tax breaks adopted by the government. In contrast to previous years, the programme contains ample information on key fiscal measures and their respective quantitative effects. An assessment on the cyclical position of the economy and the cyclically adjusted profile of fiscal policy is provided, but the programme would have benefited from a more in-depth assessment of automatic stabilisers in the context of an economic slowdown. The sensitivity analysis is welcome, but the situation in 2009 has demonstrated that potential fiscal risks appear to be much more elevated than those presented in the programme. The programme makes an attempt to apply ESA95 standards and fiscal data are broadly consistent with those presented in the recent fiscal notification submitted.

The fiscal programme envisages an improvement of the consolidated general government balance, from an expected deficit of 6.6% of GDP in 2009 to a 4.7% deficit in 2010, 3.5% in 2011 and 2.7% in 2012, largely in line with the growth scenario. The public spending ratio increased by over five percentage points of GDP in 2009, as social security transfers increased significantly by almost 2 percentage points of GDP, together with interest payments and other current spending. It is projected to stabilise in 2010 at just above 40% of GDP, and subsequently fall to 38.8% in 2011 and 37.8% in 2012. . At the same time, the revenue-to-GDP ratio is planned to increase by about 2 percentage points over 2009 to 2012, which seems ambitious in the present crisis context. The general government debt ratio is projected to fall by around 2 percentage points in 2009-2012, from 49.0% of

GDP in 2009 to 47.8% of GDP in 2012, mainly driven by an acceleration of nominal GDP growth and the reduction of the fiscal deficit. In view of the above mentioned risks to fiscal revenue, and possible higher deficit outcomes, public debt may increase to higher levels.

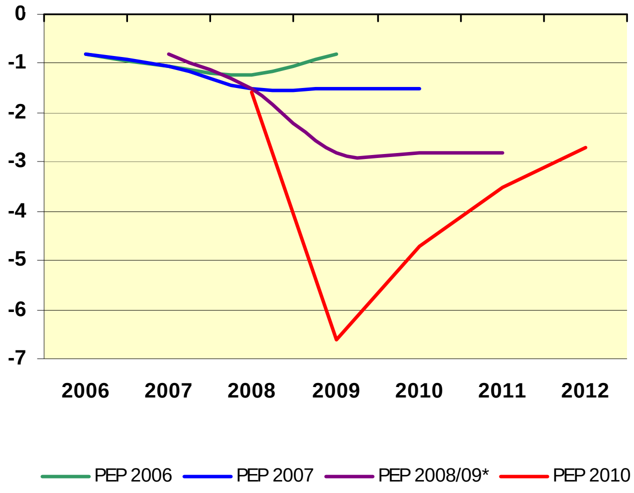
3.5.1. Budget implementation in 2009

As for the year 2009, the original budget framework presented in last years' PEP (and adopted in late 2008) foresaw a budget deficit for the consolidated general government sector of 4.6% of GDP, 3 percentage points (pps) higher than in 2008. However, while the budget revenue target was virtually met, spending went up by about 2 pps, mainly due to the larger than budgeted transfers to the social security and the sizable stimulus package. The deficit of the Social Security Institution (SGK) amounted to TRL 32 billion (EUR 16 billion) at the end of the year, more than half of the entire 5.5% of GDP budget deficit. Healthcare costs have quadrupled to TRL 28 billion since 2002. The PEP does not provide the most recent information on budget execution in 2009, which is a major shortcoming. Data presented for 2009 are outdated and show the broad picture, but fail to adequately quantify the link between budget performance and the business cycle and/or policy related events.

3.5.2. Medium-term budget strategy

The parliament adopted in late December 2009 the central government budget for 2010, targeting a fiscal deficit of 2.1% of GDP, which coincides according to the PEP with a general government deficit of 4.7% of GDP. The authorities expect real GDP growth of 3.5%, while inflation is projected at 6.4%. Revenues and expenditures amount respectively to 35.7% and 40.3% of GDP. This budget is fully in line with the Medium Term Fiscal Framework and the PEP.

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



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

The 2.2 percentage points increase in the share of revenue to GDP in 2010 appeared somewhat optimistic, assuming that the tax elasticity remains constant in the short term. The expenditure-to-GDP ratio in 2010 remains roughly constant. In contrast with 2009, social transfers and subsidies are projected to remain constant at about 6.7% of GDP. Interest payments are budgeted to fall from 6.4% of GDP in 2009 to 6% of GDP in 2010, which appears largely consistent with the current short-term expectations, as regards the pricing of Turkey's sovereign debt.

In 2011, the general government deficit is projected to decrease to 3.5% of GDP, before further declining to 2.7% of GDP by 2012. A major part of the adjustment over these two years is planned to be realised through a reduction of public consumption and interest payments, each by almost 0.5 percentage point annually. The programme does not elaborate in much more detail on this spending adjustment which may appear somewhat ambitious.

As explained earlier, fiscal risks are clearly related to the downside risks to the growth assumptions of the programme. A weaker recovery is likely to worsen the fiscal balance. Additional risks may result from a slower than envisaged implementation of reforms which could delay the realisation of budget savings. This refers in particular to spending pressures on current expenditures and social transfers in the year before elections. Pressures to slowdown the exiting of short-term crisis-related discretionary spending cannot be ruled out either. The combined effect of lower fiscal revenues and pressures for higher current spending would undermine the envisaged fiscal path. Therefore, both fiscal measures to reign in current spending and the introduction of a binding and strong fiscal rule as of 2011 are required to ensure public finance sustainability and enhance confidence from economic agents.

Table II.3.3:

Composition of the budgetary adjustment (% of GDP)

	2008	2009	2010	2011	2012	Change: 2009-12
Revenues	33.1	33.5	35.7	35.3	35.1	1.6
- Taxes and social security contributions	24.7	25.0	27.2	27.3	27.2	2.2
- Other (residual)	8.4	8.5	8.5	8.0	7.9	-0.6
Expenditure	34.7	40.1	40.3	38.8	37.8	-2.3
- Primary expenditure	29.1	33.7	34.3	33.6	33.0	-0.7
of which:						
Gross fixed capital formation	3.4	3.2	3.3	3.0	3.1	-0.1
Consumption	15.8	17.9	17.9	17.4	16.9	-1.0
Transfers & subsidies	4.8	6.7	6.8	6.6	6.7	0.0
Other (residual)	5.1	5.9	6.3	6.6	6.3	0.4
- Interest payments	5.6	6.4	6.0	5.2	4.8	-1.6
Budget balance	-1.6	-6.6	-4.6	-3.5	-2.7	3.9
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	4.0	-0.2	1.4	1.7	2.1	2.3
Gross debt level	39.5	47.3	49.0	48.8	47.8	0.5

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

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

The PEP 2010-2012 provides an overview on the cyclical position of the economy and the impact of fiscal policy, using the same methodology in estimating cyclically adjusted primary balances as in the 2009 submission. On this basis, estimated potential growth would markedly exceed real output over the entire PEP-period. As of 2010, the structural and actual primary budget balances would start to differ less and the actual budget deficit would recede. It is estimated that the cyclically adjusted primary budget surplus which was 2.2% of GDP in 2008, will stabilize at about 1% in 2009-2012. On this basis, the PEP concludes that fiscal policy has pro-cyclical effects in 2010-2012. Given the methodological weaknesses, the statements on the effects of fiscal policy certainly need to be taken with caution.

3.5.4. Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

The PEP 2009-2011 projects a baseline scenario of a gradual decrease of general government debt from its 49% of GDP peak in 2010 to 47.8% of GDP in 2012. Projections on the decomposition of changes in the debt ratio appear sufficiently comprehensive and consistent with the macro-economic and fiscal assumptions. The nominal GDP effect and the projected improvements of the primary balance in 2011 has a marked effect on the decrease of the debt ratio. The public debt sensitivity analysis presented in the PEP shows that the public debt ratio could increase by about 6.6 percentage points by 2012 under a scenario combining several shocks, namely a fall in growth by 2%, a depreciation of the TRL by 5% and a real interest rates increase by 500 base points. The analysis is useful and confirms the need for continued fiscal discipline in order to ensure public debt sustainability. However, current uncertainties regarding growth prospects may justify some analysis on the sensitivity of public debt to a larger growth contraction in the next programmes, and to subsequently worse fiscal balance outcomes. Public debt management aims at implementing accountable, transparent and sustainable borrowing policies which are compatible with the monetary and fiscal policies. Besides, strategic benchmarks are being used in order to ensure the optimal cost target in the medium and long term at a reasonable risk.

Table II.3.4:

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

	2008	2009	2010	2011	2012
Gross debt ratio [1]	**39.5**	**47.3**	**49.0**	**48.8**	**47.8**
Change in the ratio		7.8	1.7	-0.2	-1.0
Contributions [2]:					
1. Primary balance		**-0.5**	**0.9**	**-2.5**	**-0.6**
2. “Snow-ball” effect		**8.4**	**0.9**	**-5.6**	**-9.6**
Of which:					
Interest expenditure		0.1	0.1	-2.5	-0.6
Growth effect		0.0	4.7	1.6	-0.1
Inflation effect		8.3	-3.9	-4.7	-8.9
3. Stock-flow		**-0.1**	**-0.1**	**7.9**	**9.2**

Notes:

[1] End of period.

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

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

As of October 2009, 75% of the debt stock was financed domestically, while the share of the debt stock denominated in TRL increased by one percentage point to 70.3%. However, the share of debt with a fixed interest rate has decreased from 57% in 20008 to 52.9% by the end of 2009 Conversely, the cost of TRL denominated discount borrowing decreased from 19.2% in 2008 to 11.9% in October 2009. Although the average maturity of the domestic debt stock remains relatively low, it went up from 23.9 months in 2008 to 25.4 months in late 2009. The average maturity of the foreign debt stock is significantly longer and amounted to over 60 months, unchanged from 2008.

3.5.5. Budgetary implications of "major structural reforms"

As required, the programme (in its Annex) presents some estimates of the fiscal impact of reforms envisaged over the PEP horizon, which is a useful complement. A summary overview is presented in table II.2.5 of this assessment. It shows that structural reforms will have a significant impact on the country's fiscal position. The rural development reform, if coming into effect with the currently specified parameters, is expected to impose an additional burden of about 1.0% of GDP on the budget in 2010-2012. The social security reform project is expected to be finalized in 2010 and may generate budgetary savings amounting to 0.01% of GDP in total.

3.5.6. Sensitivity analysis and comparison with previous PEP

As in last year's PEP, various sensitivity analyses are presented. One scenario examines the sensitivity of public finances to lower growth and higher interest rates. According to the calculations presented in the PEP, the debt situation appears to be sustainable. The most critical scenario is that of a combined shock, with a depreciation of the TRL of 5% in effective terms, a 2 percentage points decrease in real growth and 500 base points increase in real interest rates compared to the baseline scenario, whereby the gross debt level would rise/fall by 6.6 percentage points. While the analysis concludes plausibly that the sensitivity of the debt stock has fallen, this argument could be strengthened by the inclusion of more critical scenarios, in particular in view of the size of the current contraction of growth observed in 2009 worldwide.

3.5.7. Quality of public finances and institutional features

The PEP 2010-2012 refers in a very general way to recent and ongoing institutional changes and policies which are deemed to improve the quality of public finances over the medium term. It emphasises improvements in budget management, revenue collection and expenditure control as well as the adoption of a new public procurement system in line with EU practice and a new legal framework for public-private partnerships. In order to reduce the need for ad-hoc measures to reach fiscal targets, it also foresees intensified efforts to widen the tax base, better capture the unregistered economy, and decrease the number of tax exemptions. Turkey has accomplished a remarkable effort of fiscal consolidation but ensuring a high-quality fiscal adjustment will be a key challenge in the coming years.

As public expenditures are already relatively high there is limited scope for Turkey to increase expenditure in order to meet pressing convergence challenges. Expenditure will also be contained in order to make room for lower taxes in the long run while preserving a sound fiscal framework. Fiscal policy would thus need to focus on trade-offs in expenditure allocations, possibly by reducing spending in functional areas - where it appears to be oversized in comparison with other similar countries. At the same time, additional reforms will need to be implemented with the aim of improving the efficiency of expenditure programmes in areas where expenditure pressures are being increasingly felt, such as health care, education, social protection. Reforms focused on the modernization of civil service pay and employment system and the rationalization of the investment programme, will also help contain pressures on the wage bill as well as investment spending and thus contribute to better control public expenditure across functional areas. Efficiency considerations are considered to be the main priority in public expenditure policies.

The Turkish authorities have embarked on an ambitious reform by establishing a revenue administration. This reform intends to increase the efficiency of tax collection, by means of enhancing automation, training staff and improving all underpinning facilities the tax system will also be simplified and rationalized. Public expenditures will be prioritized with respect to resource scarcity and their impact on potential growth. In this context, some activities and projects of lower priority will be eliminated and the thereby created fiscal space will be allocated to expenditure priorities with assumed growth potential.

3.5.8. Sustainability of public finances

Even in case of a full implementation of the reform proposals, Turkey is not so well placed to meet the costs of an ageing population. The introduction of a new and responsible social security system, and more generally, the future costs of the pension and health-care systems should therefore be monitored very carefully.

Unlike previous PEPs, the PEP 2010-2012 contains no analysis of the long-term sustainability of public finances with a focus on key parameters, like pension, health and interest expenditure. Assumptions on long-term population trends as well as on participation rates may not have changed compared to last year's PEP. However, differences to last year's scenario may stem from the significantly lower growth rates due to the ongoing crisis. In spite of the large deficits in the social security system, the programme does not mention additional reforms in the area of healthcare, pension, or labour markets which would improve the long term sustainability of public finance. The obvious challenges arising from demographic pressures remain significant, also in view of an already relatively high public debt ratio and a very low participation rate. Given the risks and magnitude of challenges, the programme would have benefited from outlining a somewhat more thorough policy response.

3.6. STRUCTURAL REFORMS

The general aim of the PEP's 2010-2012 structural reform agenda is to increase the efficiency in the private sector and the public administration and to support the strengthening of market forces. Being an update from the plans put in place over the last years, it covers a broad range of structural reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, health care, judiciary, and environment. The presentation is often backward looking, providing information on past and ongoing reform initiatives with a strong emphasis on harmonisation with EU requirements. The programme contains fiscal impact estimates on some measures, but the link between the structural reform agenda and the implementation of the fiscal strategy could be further strengthened. The full implementation of the structural reform agenda would in some cases require the establishment of time bound action plans and the definition of concrete measures and clear targets. The outlined reforms are at different stages in their implementation. The programme is quite clear on results and delays compared with what was outlined in the previous PEP. In some areas, however, e.g. competition policy and the investment climate, the programme would benefit from some explanation of the targeted results and on the speed of operation. The budgetary effects of reforms to be implemented are outlined for all major reform areas, although cost estimates beyond 2010 are often lacking. Even more emphasis should be put on labour market reforms in order to support job creation during the economic transformation process. As in previous years, the PEP also lacks clear policies and descriptions concerning research and development and innovation, an area which would be important to support a transformation to a knowledge-based economy. Intensified efforts to speed up the implementation of reforms, in particular in the areas of enterprise restructuring, education and labour markets would be supportive to the fulfilment of the second Copenhagen economic criteria over the medium term.

3.6.1. Product and capital markets

The PEP 2010-2012 touches upon main reform areas such as the strengthening of competition policy and state aid control, privatisation, enterprise restructuring (railway sector, shipbuilding) and SME development. It also envisages a continuation of measures aimed at strengthening the legal and institutional framework and a further harmonisation with EU requirements, which is welcome. The PEP rightly highlights the successful continuation of the privatisation process during 2009, which constitutes indeed a real achievement during the current crisis. However, delays have been encountered in certain sectors compared to what was envisaged in the previous PEP. Privatisation efforts are to continue during the programme period, for example, in banks, energy, ports and activities related to the sugar and petrochemical industry.

Table II.3.5:
Net direct budgetary impact of key reform commitments (in EUR million)

	2010	2011	2012
Labour market	-1.0	-1.0	0.0
Agriculture	-810.0	0.0	0.0
Rural development	-2,708.5	-2,773.1	0.0
Social security	42.1	43.0	43.0
Transportation	-0.5	0.0	0.0
Total impact on the budget	-3,477.9	-2,731.1	43.0
Total impact on the budget (in % of GDP)	-0.7	-0.5	0.0

Source: 2010 Pre-accession Economic Programme (PEP), ECFIN calculations

There is a risk that further delays will occur during the programme period compared to the outlined plans. After three years of relatively intensive privatisation, the remaining portfolio of state-owned enterprises is likely to be more challenging to privatise: it is concentrated in areas where privatisation can be seen as more sensitive.

Concerning the area of competition law and policies, no progress since the 2009 PEP has been achieved in putting in place a consistent monitoring of state aids, which continues to negatively affect transparency and the overall competitive environment. Further steps are planned improve the business environment where a positive development has been the facilitation and simplification of the sectoral licensing process. A well-established policy framework, including for example via the Investment Advisory Council, continues to support the reform process and to identify problematic issues for investors. However, the PEP contains very limited information on issues that will be addressed over the programme period.

In the field of banking, the privatisation of the largest state bank, Ziraat Bank, has been delayed but overall, past and planned measures are supportive of the overall positive developments in the sector. Despite the demonstrated improved resilience of the Turkish banking sector to severe market fluctuations, also thanks to a number of specific supervisory measures , a continued strengthening of supervision will be important to further decrease risks in particular in the context of the still rapidly growing banking operations. Concerning capital markets, several legal acts were put into effect in order to protect investors in capital markets and create a more stable and efficient market in line with the EU acquis. The programme gives a thorough overview of recent and planned measures aimed at aligning the financial sector legislation and in particular prudential regulations with EU requirements. This process appears to be well on track. The programme could have discussed in more detail the new challenges for domestic financial and capital markets stemming from possibly lower profitability as funding may become more expensive and as the monetary easing is likely to be reversed.

3.6.2. Labour market

Like in previous years, the programme underlines the main problems and challenges in the Turkish labour market, such as the very low participation rates, the ongoing sector shifts, and the growing population of working age. It also shows that there has been a significant worsening in unemployment since the last PEP. The programme strongly emphasises the link between the labour market and the education sector and the need to reduce the skills mismatch between labour demand and supply. Since the submission of the last PEP, some measures have been taken, for example to smoothen paths in upper secondary education and to increase the availability of higher education. Looking forward, the PEP is quite vague on concrete measures that will be taken to further improve educational standards, apart from continuing the Privatization and Social Support Project and the Basic Education Programme. There is insufficient information about the planned scope for active labour market policies or resources which will be put aside for this purpose. The PEP does not mention the action plan, adopted by the government, to combat the informal economy, and its targets and indicators to reduce the size of the underground economy.

In spite of some new targeted initiatives, non-wage labour costs remains generally high and the regulations of the labour market rigid. Tackling these issues in a more systematic way would help addressing the identified challenges in the labour market, reduce informality, and support the creation of jobs in the challenging recovery period ahead. The programme proposes to further reduce the cost of employment by introducing some measures, but the timing is not always clear.

3.6.3. Other reform areas

The PEP outlines a wide range of areas where reform efforts have been ongoing and are foreseen to continue over the programme period. Further efforts have been made to improve efficiency in the agricultural sector, the public administration, the health and social security system, transportation, and some other areas, which are yielding positive results, e.g. for the budgeting process and transparency. However, the information provided appears in many cases rather piecemeal and often the further steps to be taken remain vague. Local governments' reform is important in order to strengthen their role and abilities to perform the needed services. Legal reforms have proceeded, but the PEP acknowledges that there are deficiencies in the capacity to implement laws at the local level.

Efforts have been ongoing to raise the efficiency and production standards in the agricultural sector, for instance through support for rural development investments. Work continued to prepare for the implementation of the EU's Common Agricultural Policy. The PEP outlines the budgetary effects of a number of planned reforms. Several projects are estimated to carry relatively large positive net effects on the budget, thereby limiting the overall net costs, but it remains unclear from the programme how these funds will be generated.

3.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework. The programme presents a clear and concise picture of past economic developments and covers most relevant data in an accurate way. The PEP presents a comprehensive and largely consistent medium-term macroeconomic framework.

Fiscal framework. The fiscal programme is largely consistent with the macroeconomic framework. The programme's fiscal targets square well with the growth scenario. The programme benefits from more concrete information on the fiscal stimulus measures than in previous years. Historic data are fully in line with data submitted in the context of the 2009 fiscal notification.

Structural reforms. To serve as a useful policy tool for the implementation of structural reforms, the programme would benefit from the definition of clear policy targets, concrete measures and a timeframe for implementation.

Table II.3.6:

Annex: Structural indicators

	Turkey					EU 27				
	2005	2006	2007	2008	2009	2005	2006	2007	2008	2009
General economic background										
Real GDP [1]	8.4	6.9	4.7	0.9	-5.8	2.0	3.2	2.9	0.8	-4.2
Labour productivity [2]	58.0	61.4	62.5	63.5	62.2	100	100	100	100	100
Real unit labour cost [3]	n.a.	n.a.	n.a.	n.a.	n.a.	-0.6	-1.2	-0.6	0.5	2.2f
Real effective exchange rate [4]	113.8	123.2	120.6	130.3	n.a.	107.5	106.4	107.9	114.0	n.a.
Inflation rate [5]	8.1	9.3	8.8	10.4	6.3	2.2	2.2	2.3	3.7	1.0
Unemployment rate [6]	10.2	8.4	8.9	9.8	14.1	8.9	8.2	7.1	7.0	8.9
Employment										
Employment rate [7]	46.0	45.9	45.8	45.9	n.a.	63.5	64.5	65.4	65.9	n.a.
Employment rate - females [8]	23.8	23.9	23.8	24.3	n.a.	56.3	57.3	58.3	59.1	n.a.
Employment rate of older workers [9]	31.0	30.1	29.5	29.5	n.a.	42.3	43.5	44.6	45.6	n.a.
Long term unemployment [10]	3.5	2.5	2.3	2.3	n.a.	4.1	3.7	3.1	2.6	n.a.
Product market reforms										
Relative price levels [11]	66.7	66.4	71.9	71.4	n.a.	100	100	100	100	100
Total trade-to-GDP ratio [12]	19.8	21.6	21.4	22.7	n.a.	9.8	10.7	10.8	11.4	n.a.
Net FDI [13]	1.2	2.0	1.9	2.1	1.6e	1.7	2.3	3.8	2.2	n.a.
Sectoral and ad-hoc state aid [15]	n.a.	n.a.	n.a.	n.a.	n.a.	0.6	0.6	0.5	n.a.	n.a.
Business investment [16]	17.4	13.3	5.5	n.a.	n.a.	17.7	18.2	18.7	18.4	n.a.
Knowledge based economy										
Tertiary graduates [17]	5.7	6.2	n.a.	n.a.	n.a.	13.2	13.0	n.a.	n.a.	n.a.
Spending on human resources [18]	n.a.	2.9	n.a.	n.a.	n.a.	5.0	5.0	n.a.	n.a.	n.a.
Educational attainment [19]	44.0	44.7	46.4	47.8	n.a.	77.5	77.9	78.1	78.5	n.a.
R&D expenditure [20]	0.6	0.6	0.7	n.a.	n.a.	1.8	1.9	1.9	1.9	n.a.
Broadband penetration rate [21]	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	18.2	21.7	23.9

1. Growth rate of real GDP in %. 2. Labour productivity per person employed - GDP in PPS per person employed relative to EU-27 (EU-27=100). 3. Growth rate of the ratio: compensation per employee in current prices divided by GDP (in current prices) per total employment. 4. Vs IC36 (1995 = 100), current year's values are based on Commission's forecast deflator figures, nominal unit labour cost deflator. 5. Annual average rate of change in Harmonized Indices of Consumer Prices (HICPs), tFYRoM = CPI. 6. Unemployed persons as a share of the total active population. 7. Employed persons aged 15-64 in % of total population of the same age group. 8. Employed women aged 15-64 in % of total female population of the same age group. 9. Employed persons aged 55-64 (EU27) or 50-64 (tFYRoM)) in % of total population of the same age group. 10. Long-term unemployed (over 12 months) in % of total active population. 11. comparative price levels of final consumption by private households including indirect taxes (EU-27=100). 12. Trade integration - Average value of imports and exports of goods divided by GDP.

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

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

Source: Commission services, national sources