European Commission

EUROPEAN ECONOMY

Occasional Papers 97 | June 2012

2012 Economic and Fiscal Programmes of Albania, Bosnia and Herzegovina: EU Commission's overview and country assessments

Economic and Financial Affairs

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ISBN 978-92-79-22876-6
doi: 10/2765/20972

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2012 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania and Bosnia and Herzegovina).

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

For this reason a similar, though reduced, exercise was started in 2007 with the potential candidate countries, with the submission and assessment of annual EFPs as an important element. The EFPs have two objectives: first, to outline a medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession; and, second, to offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU with a derogation in regards to the adoption of the euro upon accession, particularly in the areas of multilateral surveillance and co-ordination of economic policies. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect ensuring the success of the Pre-Accession Fiscal Surveillance Procedure.

The programmes have been made public by the countries and can be found on the internet under following addresses:

Albania
http://www.minfin.gov.al/minfin/pub/economic_and_fiscal_program_2012_2014_final_3068_1.pdf

Bosnia and Herzegovina
http://www.dep.gov.ba/dep_publikacije/publikacije/Default.aspx?id=1500

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The programmes and their assessments by the Commission services were discussed during an experts meeting on 23 May in Brussels, with experts from the potential candidate countries, EU Member States, the European Central Bank and Commission services.

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Part I

Overview

1. OVERVIEW

1.1. BACKGROUND

In the context of the fiscal surveillance of potential candidate countries, the Commission invited Albania and Bosnia and Herzegovina to submit their annual *Economic and Fiscal Programmes* (EFPs) covering the period 2012-2014 by 31 January.([1]) Both programmes were made public.([2]) The preparation, assessment and discussion of these programmes serve to strengthen economic planning capacity in the countries and prepare them for participation in the economic and fiscal surveillance procedure of candidate countries and, eventually in the more distant perspective of accession, in the economic policy co-ordination and budgetary surveillance mechanisms of the Economic and Monetary Union (EMU).

The 2012 EFPs represent a step forward towards meeting this objective. The programmes generally contain useful overviews of medium-term macroeconomic and fiscal scenario and address economic policy plans on a broad range of policy areas. In some cases they show the determination of the governments to advance further stabilisation, structural reforms and productivity gains in order to allow sufficiently high growth, catching up with the EU Member States and higher standards of living in the countries. The programmes' degree of ambition and precision with respect to sequencing of reforms and time lines for implementation varies across policy areas.

1.2. THE 2012 PROGRAMMES

The 2012 programmes were prepared against a background of deteriorating EU and global economic conditions which remain uncertain. The exposure of potential candidate countries to the EU and specifically to euro area economies implies that external shocks can be transmitted at varying degrees through the trade, remittances and financial and investment channels. Bosnia and Herzegovina foresees a slowdown in GDP growth in 2012 before rebounding in 2013-14. Albania projects an acceleration in economic activity in 2012 and 2013, albeit at a slower pace than the historical values. Both programmes anticipate a continuing decline in fiscal deficits, with Bosnia and Herzegovina targeting a budget surplus in 2013.

In line with the reporting requirements for Pre-Accession Economic Programmes (PEPs) to be prepared by candidate countries, the Commission asked potential candidate countries – as a first step – to put more emphasis in the 2012 programmes on the assessment of the sustainability of the external position and on the main structural obstacles to growth. The 2012 EFPs reveal that potential candidate countries had difficulties to fully adhere to the requested alignment of their programmes and in particular to provide a more forward-looking assessment on external sustainability and growth-enhancing structural reforms.

([1]) Bosnia and Herzegovina's EFP was submitted late having been endorsed by the Council of Ministers only on 21 March.
([2]) Albania: http://www.minfin.gov.al/minfin/pub/economic_and_fiscal_program_2012_2014_final_3068_1.pdf
Bosnia and Herzegovina:
http://www.dep.gov.ba/dep_publikacije/publikacije/Default.aspx?id=1500

2012 Economic and Fiscal Programmes: Key indicators

	2008	2009	2010	2011	2012	2013	2014
Growth (GDP, real, annual % change)							
Albania	7.5	3.3	3.9	3.0	4.3	5.0	4.9
Bosnia and Herzegovina	7.0	-1.8	1.0	2.4	2.1	4.0	4.8
Unemployment rate (%, LFS)							
Albania	12.8	13.0	13.5	12.9	12.1	11.4	10.6
Bosnia and Herzegovina	23.4	24.1	27.2	27.6	27.9	27.4	25.8
Current account balance (% of GDP)							
Albania	-15.5	-15.1	-11.7	-12.5	-11.7	-10.9	-8.9
Bosnia and Herzegovina	-12.3	-5.5	-4.9	-8.4	-9.6	-10.0	-9.9
Inflation (CPI, annual % change)							
Albania	3.4	2.3	3.6	3.5	3.0	3.0	3.0
Bosnia and Herzegovina	7.4	-0.4	2.1	4.0	1.9	1.8	1.6
Government balance (% of GDP) *							
Albania	-5.5	-7.0	-3.1	-3.5	-3.0	-3.0	-2.5
Bosnia and Herzegovina	-1.9	-3.8	-2.1	-1.3	-1.1	0.2	1.1
Government gross debt (% of GDP) *							
Albania	54.8	54.8	54.1	55.2	55.4	55.1	54.3
Bosnia and Herzegovina	26.5	29.8	32.9	32.9	33.0	30.3	26.2

* general government, national acc. standards

Source: Economic and Fiscal Programmes (EFP) 2012 and national sources

Both countries envisage domestically-led economic growth, with investment being the most dynamic component. According to the programmes, Albania's GDP growth decelerated in 2011, while Bosnia and Herzegovina registered a faster pace of growth. Albania forecasts output growth to rebound to 4.3% in 2012 and increase further to 5% in the outer years. Bosnia and Herzegovina's GDP growth is set to moderate to 2.1% in 2012 before picking up to 4% and 4.8% in 2013 and 2014, respectively.

Albania's current account deficit is foreseen to improve over the programme horizon, while the sharp deterioration of Bosnia and Herzegovina's external account in 2011 is set to continue before stabilising in 2014. Both programmes fail to comply with the Commission's requirement to present an analysis of the medium-term sustainability of the country's external position. Overall, the EFP's macroeconomic scenarios tend to be on the optimistic side and face downside risks, most notably a worsening external economic climate.

The programmes project a reduction in the budget deficit over the programme period. Following an increase in 2011, Albania's deficit is expected to decline to 3% of GDP this year and remain at this level in 2013 before falling to 2.5% in 2014. For Bosnia and Herzegovina, the improvement in the budget balance since 2010 is anticipated to continue with the fiscal deficit turning into a surplus in 2013. Albania's fiscal adjustment over the period 2011-14 is to some extent evenly spread and planned to be achieved mostly through a higher revenue-to-GDP ratio, while for Bosnia and Herzegovina the largely back-loaded consolidation will be driven primarily by a reduction in the expenditure-to-GDP ratio.

The structural reforms spelled out in the 2012 EFPs should be further elaborated in order to ensure a credible basis for future reform agendas. Both programmes fail to identify and provide an in-depth analysis of the structural obstacles to growth as requested by the Commission. Albania's reforms focus on the improvement of the business environment, including facilitating business creation. For Bosnia and Herzegovina, the focus is mostly on privatisation, the labour market, social protection system and public administration reforms. In most instances, the presentation of reforms in the EFPs is backward-looking and would benefit from more clarity when explaining future reform plans and their implementation. Moreover, the EFPs would have gained from a more explicit discussion of the links between structural reforms to the macroeconomic and fiscal frameworks.

1.3. COUNTRY-SPECIFIC SUMMARY

Albania's EFP presents an optimistic macroeconomic scenario, especially for 2012, when GDP is forecast to accelerate to 4.3% and reach some 5% by 2014. Inflation is expected to fall to 3% and remain at this level over the programme's horizon, while labour market conditions are set to improve. According to the programme, the current account imbalance is expected to decline. The budget deficit is planned to fall from 3.5% of GDP in 2011 to 3% in 2012 and 2013 before reaching 2.5% by the end of the programme period. The budgetary consolidation is projected to be primarily led by a higher revenue-to-GDP ratio. The favourable GDP outlook and higher-than-average tax elasticities underpinning the programme's fiscal scenario make revenue projections appear optimistic and could render even the rather modest consolidation targets challenging to achieve. Net of guarantees, the government debt is expected to reach a peak of 55.4% of GDP in 2012 and to decline somewhat thereafter. The short-term bias of the debt gives rise to roll-over and interest rate risk. The programme would have benefitted from a forward-looking elaboration of the structural reform agenda. Timetables for the implementation of key reform measures together with their budgetary impact are largely missing.

Against a background of volatile global economic conditions, Bosnia and Herzegovina's macroeconomic framework appears optimistic. GDP growth is set to slow down to 2.1% in 2012 and thereafter rebound to 4.8% by 2014. Domestic demand is expected to remain the main driver of growth, although exports will also rise in the outer years. Inflation is foreseen to ease while employment growth is set to accelerate in the period 2013-14. The current account deficit is anticipated to widen to about 10% of GDP in 2014. The programme aims at an expenditure-led fiscal consolidation of 2.4 percentage points of GDP by 2014, but the precise policy measures to support the required adjustment are not elaborated. The fiscal scenario appears to be inconsistent with the macroeconomic framework. Although some progress has been achieved compared to the previous programme in terms of structural reforms, there remains ample scope for improvement by supporting reform intentions with specific measures and quantifying their budgetary cost. Reform efforts also seem uneven across the country.

1.4. THE EFPS AND THE PRE-ACCESSION STRATEGY

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

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

The EFPs are gradually enabling the authorities to develop and communicate consistent economic, fiscal and structural policies over the medium-term. Their preparation serves a twofold purpose: to strengthen economic planning capacity in the countries; and to specifically prepare them for participation in the economic policy co-ordination and budgetary surveillance mechanisms of EMU. Although more limited in scope, the timing, structure and methodology of the EFPs, mirrors the PEPs submitted since 2001 by candidate countries. The EFPs and their assessments are discussed in a multilateral setting with the Commission services, potential candidate countries and Member States. The development of the institutional capacity to co-ordinate between the various ministries, government agencies and the central bank is a particularly important aspect, ensuring the success of the Economic and Fiscal Programmes.

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

The programmes spell out policy strategies which, to a large extent, are compatible with and conducive to the fulfilment of the economic priorities of the European Partnerships. Overall, the full and determined implementation of the announced reforms should strengthen the countries' economies, in particular in view of the fulfilment of the Copenhagen economic accession criteria, i.e. establishing a functioning market economy and enhancing competitiveness thereby allowing the countries to cope with competitive pressure within the European Union.

1.5. FOLLOW-UP

The programmes and their assessments by the Commission services were discussed during an experts meeting on 23 May in Brussels, with experts from the potential candidate countries, EU Member States, the European Central Bank and Commission services.

As this exercise was conceived to be on an annual basis, the countries will next year be invited to submit a programme covering the period 2013-2015.

Part II

Country analysis

1. ALBANIA

1.1. SUMMARY AND CONCLUSIONS

Albania submitted the 2012 Economic and Fiscal Programme (EFP), covering the period 2012-2014, on 3 February. The programme's key objectives remain unchanged from the previous EFP and include macroeconomic stability, fiscal consolidation, while maintaining a still high level of public investment, and sustaining economic growth with a view to achieve a fast convergence with EU income levels. The programme is a policy coordination instrument based on several medium-term government strategies. It broadly follows the requirements on format and content of the European Commission, although it has some data gaps while public finance data do not comply with the ESA95 methodology.

Notwithstanding anaemic global economic growth, Albania's real GDP grew by an estimated 3% in 2011.([3]) Inflation eased significantly in the second half of the year while external imbalances increased. The programme's macroeconomic outlook projects an acceleration of real GDP growth to 4.3% in 2012 and an annual average of some 5% in the outer years. In the context of a volatile global and regional economic and financial situation and unresolved domestic vulnerabilities, the projected GDP growth appears to be optimistic, especially for 2012. In particular, Albania's banking sector is significantly exposed to a potential spill-over in the event that financial conditions in the EU, the banking system deteriorate further. While being generally well-capitalised and liquid, faces several risks which in general are appropriately identified and discussed in the programme. A high and rising level of non-performing loans (NPLs) and tight lending conditions could weigh on economic growth. Worsening economic conditions in the EU and specifically in Greece and Italy, Albania's main trading partners, would also adversely affect economic performance. The EFP presents a rather optimistic outlook of the external sector and does not analyse its sustainability and competitiveness.

According to the programme, the government deficit reached 3.5% of GDP in 2011 which, although in line with the target envisaged in the original budget, was achieved only after a mid-year re-balancing. The programme's medium-term fiscal scenario projects a decline in the budget deficit to 3% of GDP in 2012. The favourable macroeconomic scenario together with the relatively high tax elasticities assumed in the programme make the budget target optimistic, especially for 2012. The programme anticipates a mild deficit adjustment in the outer years, stabilising at 3% in 2013 and 2.5% of GDP in 2014 and provides no indication on the underlying fiscal strategy. The treatment of risks to the budgetary outlook is insufficient. The EFP envisages a slower pace of decline in the public debt compared to that foreseen in last year's EFP. The programme does not provide a quantitative assessment of the long-term sustainability of public finances.

The EFP does not identify the structural obstacles facing Albania's economic growth but only focuses on short term risks. Reforms aimed at improving the business climate were less far-reaching in 2011, although some progress was recorded. Building permits procedures are lengthy, access to finance remains a major obstacle to business while the programme does not provide concrete plans to address the long-standing issue of property rights. Further progress is warranted in tackling impediments particularly by upgrading the physical infrastructure, especially energy and transport, strengthening human capital and improving the functioning of the labour market. The EFP's treatment of structural reforms is rather backward-looking, while it lacks a quantification of the budgetary impact of the measures. The document does not contain a matrix of policy commitments and does not feature any policy priorities.

([3]) Since the submission of the programme, official quarterly data show an estimated real GDP growth of 3.1% in 2011.

The main risks associated with the programme include: (i) the favourable macroeconomic scenario, especially for 2012, which makes tax projections and therefore budgetary outcomes appear optimistic; (ii) an increase in public debt in the event that the fiscal targets are missed; and (iii) a prolonged slow pace of implementing structural and institutional reforms, especially in view of the still-fragile domestic political situation.

1.2. INTRODUCTION

Albania's sixth EFP, covering the period 2012-2014, was adopted by the Council of Ministers and submitted on 3 February 2012. The programme, which is an update of the previous year's EFP, is based on several policy documents including the 2012 budget, the Macroeconomic and Fiscal Framework 2013-15, the Medium-Term Budget Program 2012-2014, the Public Finance Strategy and the National Strategy for Development and Integration 2007-2013.

The programme outlines recent macroeconomic developments, projects the medium-term macroeconomic and fiscal framework and spells out structural reforms. The EFP does not explicitly set out Albania's progress in aligning its structural reform agenda with the requirements in the European Partnership priorities originating from the implementation of the Stabilisation and Association Agreement.

1.3. KEY POLICY CHALLENGES

In the context of the current volatile global and regional economic and financial conditions, Albania's near-term challenge is to rebuild room for fiscal manoeuvre. Post-crisis unfavourable cyclical conditions have tested the limits of fiscal revenue, while structural impediments – namely, weak institutions and the informal economy – translate into subpar tax collection. At the same time, current spending continues to increase. To a large extent, the onus for achieving budgetary consolidation has fallen on growth-enhancing public investment. Addressing these deficiencies and strengthening the budget adjustment path foreseen in the EFP would support a fiscal consolidation process that does not impinge on economic growth and leads to a lasting decline in the public debt. At the same time, tackling the high and rising NPLs would reduce vulnerabilities in the banking sector and strengthen the conditions for economic growth. Deeper and accelerated implementation of structural reforms would enhance Albania's competitiveness. In particular, tackling the significant governance and institutional gap and strengthening physical infrastructure, especially in energy, and human capital would enhance the country's attractiveness to inward investment, thereby helping reduce macroeconomic imbalances, including high unemployment and external deficit.

1.4. ECONOMIC DEVELOPMENTS AND OUTLOOK

Recent macroeconomic developments

According to the programme, Albania's real GDP grew by 3% in 2011, down from 3.9% in 2010 amid worsening international economic conditions. GDP growth in 2011 was domestically-led, with gross fixed capital formation - the main driver - rebounding by 3.6% following a contraction in the previous year. Private consumption expenditure decelerated slightly to 2.6% in 2011 from 2.9%, while government consumption expenditure shrank by 4.1%. The contribution of the external sector to economic growth was almost negligible in 2011 as the strong export performance was almost outweighed by a sharp rise in imports primarily reflecting a higher energy import bill. During 2011, inflation stood at 3.5% practically unchanged from the previous year. After reaching a peak of 4.5% in February, due mostly to higher international food and fuel prices, inflation eased in the subsequent months although it remained above the upper bound of Bank of Albania's (BoA) 2-4% inflation target range until May. By December 2011, inflation declined to 1.7% and relented further in the first months of 2012 reaching 1% in March. Official data point to a relative improvement in labour market conditions during 2011.([4]) They show that employment grew by an estimated 2% on the strength of higher non-agriculture private sector job growth, while the public sector continued to shed employment. According to the programme, the unemployment rate declined from 13.7% in 2010 to 12.9% in 2011.([5])

Table II.1.1:

Comparison of macroeconomic developments and forecasts

	2010	2011	2012	2013	2014
Real GDP (% change)	3.9	3.0	4.3	5.0	4.9
Contributions:					
- Final domestic demand	0.7	2.9	3.2	4.2	3.8
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	3.2	0.1	1.1	0.8	1.0
Employment (% change)	n.a.	n.a.	n.a.	n.a.	n.a.
Unemployment rate (%)	13.5	12.9	12.1	11.4	10.6
GDP deflator (% change)	3.5	3.1	1.1	1.2	1.2
CPI inflation (%)	3.6	3.5	3.0	3.0	3.0
Current account balance (% of GDP)	-11.7	-12.5	-11.7	-10.9	-8.9

Sources: Economic and Fiscal Programme (EFP) 2012

According to the programme, the current account deficit rose to 12.5% of GDP in 2011([6]), from 11.7% in 2010. The widening of the current account deficit reflects a deterioration in the merchandise gap and the services account as well as a significant drop in current transfers in the wake of declining workers' remittances. The EFP generally covers the main recent developments in the economy, which are however focused on and do not go beyond the second quarter of 2011. The use of more up-to-date data would have rendered the document more timely and meaningful, especially in the current fast changing external economic environment. In addition, the programme's discussion of the medium-term macroeconomic scenario is limited. Important data gaps remain a concern, especially those relating to the labour market and sustainability indicators. The need to further strengthen the statistical system, including its governance, remains essential.

Medium-term macroeconomic scenario

According to the EFP, annual real GDP is forecast to grow slightly below its 10-year historical value, averaging 4.7% over the programme period and driven mainly by domestic demand. The contribution of external demand over the period 2012-2014 is projected at an annual average of 1 percentage point of GDP growth. Average annual inflation is set to decelerate to 3% in 2012 (from an estimated 3.5% in 2011) and stabilise around the mid-point of the BoA's monetary policy target of 3±1% in the outer years. Unemployment is foreseen to decline over the programme horizon, reaching 10.6% by 2014.

([4]) It should be noted that quarterly labour market statistics are based on two sources: administrative data for the private and non-agriculture private sectors, whereas agriculture data reflected annual LFS which is assumed to remain unchanged until the next annual LFS is available. This hampers consistency across time and sub-sectors.

([5]) According to recent official data published after the submission of the programme, the unemployment rate is estimated at 13.3% in 2011.

([6]) Recently published official data put the current account deficit at 12.2% of GDP in 2011.

An improvement in the merchandise trade and services balances is expected to reduce the current account deficit from an estimated 11.7% of GDP in 2012 to 8.9% in 2014. Compared to last year's programme, the EFP expects lower output growth and a higher current account deficit in the medium term, while inflation is assumed to be almost unchanged.

The programme would have benefitted from presenting and quantifying alternative macroeconomic scenarios given considerable downside risks, notably in 2012. Specifically, the continued weakness in Italy and Greece - Albania's main trading partners – could adversely impact private consumption, investment and exports. The EFP does not provide labour market projections, including wage developments. The programme would profit from a clearer and more in-depth analysis of the drivers underlying the expected developments in the macroeconomic scenario, including those leading to the expected decline in the current account deficit. Although the macroeconomic projections presented in the EFP appear to be relatively more conservative compared to the previous vintage, they remain optimistic, especially for 2012. The risks to the programmes' macroeconomic outlook are not explicitly elaborated.

Real sector

The EFP foresees an acceleration of economic growth over the programme's horizon. Real GDP growth is forecast to reach 4.3% in 2012 thanks to stronger domestic demand and a higher contribution of net exports. Private consumption growth is expected to remain at 2.6%, which appears conservative in the wake of the programme's assumed decline in unemployment, lower inflation and improving credit conditions. Gross fixed capital formation is set to grow by almost 4% in 2012, slightly higher than the previous year. With nominal government investment planned to remain at 2011 levels, the private component, implicitly increasing at a rate around 5%, is expected to drive growth in gross fixed capital formation in 2012. Compared with the 5-year historical yearly average growth of 3.8%, such a relatively strong increase in private investment appears optimistic, especially in the context of below-the-average capacity utilisation of businesses and high NPLs which implies stricter bank credit terms. Furthermore, the adverse international economic conditions, specifically in Albania's main trading partners which are also the main source of FDI, may dampen investment. Net exports are expected to contribute slightly more than 1 percentage point to real GDP growth in 2012. Growth in exports of goods and services is anticipated to decelerate to 5%, while import growth is set to slow significantly to 1.2%. Set against the relatively strong domestic demand assumed in the programme and the historical import elasticity values, total imports for 2012 as projected in the programme seem rather subdued and could turn out to be much stronger.

For 2013-14, real GDP is projected to accelerate further to around 5%. Domestic demand is anticipated to remain the main driver of growth, while the contribution of net exports is assumed to remain at around 1 percentage point of GDP growth. Private consumption growth is foreseen to accelerate at a faster pace reaching some 3%, albeit below historical values. According to the EFP, government consumption expenditure is expected to increase by 2% and 2.5% in 2013 and 2014, respectively. Gross fixed capital formation is set to be the most dynamic component growing by an annual average of slightly more than 4.5%. Net exports are set to remain positive during the programme's outer years as exports of goods and services pick up in line with the assumed improvement in the global economic conditions.

The programme does not provide medium-term projections for employment growth and wage dynamics. Unemployment is projected to follow a downward path, declining from 12.1% in 2012 to 10.6% by 2014.

Inflation

Average annual inflation is set to fall from 3.5% in 2011 to 3% in 2012, while for the outer years the EFP assumes an unchanged inflation rate in line with the mid-point of the BoA's inflation target. Although this technical assumption is motivated by the objectives of monetary policy, it does not internalise any potential changes in policies, domestic demand pressures and the evolution of global prices –which are however acknowledged in the programme.

Monetary and exchange rate policy

The programme does not foresee any changes in the monetary and exchange rate policy. The BoA's main policy objective remains the achievement and maintenance of price stability, which is put in operation by an informal inflation target of 3% with a band of +/- 1 percentage point. The publicly announced target has been instrumental in anchoring inflation. The Albanian banking system is characterised by a relatively high euroisation. Despite a number of steps taken by the monetary authorities, the banking sectors' foreign currency assets and liabilities account for more than half of total assets – constraining monetary policy tools and the effectiveness of the monetary transmission. The programme acknowledges that euroisation limits the proper functioning of the interest rate channel but does not spell out any policy or administrative measures to enhance its effectiveness. The country's inflation targeting monetary policy stance overall continues to be appropriate and represents an important element of stability in the overall macro-fiscal medium-term framework. The BoA has reduced the key repo rate four times between September 2011 and March 2012, by a total of 100 basis points to an all-time low of 4.25%. Albania operates under a free float exchange rate regime with the value of the currency determined in the foreign exchange market. Despite a depreciation of the lek vis-à-vis the euro in the past years, and more recently increases in administered prices, price stability has been generally maintained thanks to a responsive monetary policy which has entrenched inflationary expectations.

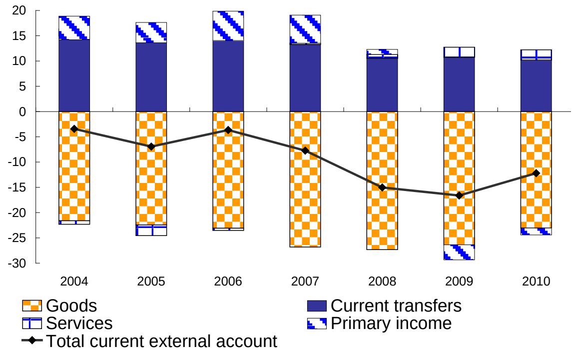
External sector

The EFP's evaluation of the external sector is limited and focuses mostly on developments in 2011. For most of the past five years, Albania's current account followed an upward trend, reaching a peak of 16.6% of GDP in 2009 (see graph II.1.1). The merchandise trade gap has been the main driver of the external account deficit. Notwithstanding an increase in exports, an expansion of private sector credit and higher investment led to rising imports - the average ratio of exports to imports amounted to 0.3 in the period 2006-2010. Workers' remittances have declined in the past five years, which was offset by a relatively dynamic FDI. The relatively safe FDI as a source of finance reduces the vulnerability posed by the high current account deficit. However, in the event of further deterioration of global financial conditions and investor risk appetite, insufficient FDI and continued declines in remittances, may lead to a sudden reversal and an abrupt adjustment in domestic demand or reserves. Structural impediments, including a weak investment climate have impinged on competitiveness and hindered the attraction of high value added foreign investment. In addition, Albania continues to suffer from a narrow production and export base suggesting that the current account deficit is structural.

The programme does not explain and analyse the reasons underlying the evolution of the current account projections, which hampers a complete assessment of the external sector. According to the programme, the current account deficit is anticipated to improve from 11.7% of GDP to slightly less than 9%. The bulk of the lower current account imbalance is due to higher anticipated exports of goods which are set to grow by a yearly average of slightly more than 16% in the period 2012-14. The surplus on the services account is also projected to increase over the programme horizon on the strength of an annual average growth of 7.7% in exports of services. Current transfers are foreseen to continue a downward trend falling from 7.6% of GDP in 2010 to 6.8% by 2014. FDI is expected to grow at an annual average of around 8%, although it will remain practically stable in terms of GDP.

Graph II.1.1: Evolution of the current account

(in % GDP)



Source: Economic and Fiscal Programme (EFP) 2012

The EFP does not analyse competitiveness issues facing the economy. The rising trend in the external imbalance coincided with a deterioration in competitiveness indicators. Although the EFP does not discuss the evolution of unit labour costs (ULC) and real effective exchange rates (REER), there are indications([7]) that total economy labour productivity has been weak in the period 2006-2010. At the same time, unit labour costs have followed an upward trend since 2006. These developments have placed Albania at a competitive disadvantage vis-à-vis its trading partners as suggested by an appreciating REER until 2008, while the apparent improvement in the subsequent years seems to be more related to a depreciation of the lek.

The programme fails to analyse the reasons underlying developments in the net international investment position (NIIP). The persistent current account deficit has led to a substantial build-up of net external liabilities along the years. In 2009, the NIIP has almost doubled as a percent of GDP, reaching -32.5% up from some -18% in 2007. Although FDI accounts for half of the external liabilities, the share of other investments has increased by almost a half over the period 2007-09.

The EFP provides projections for the expected evolution of the savings and investment balance but lacks an assessment of the external sustainability in the medium-term. According to the programme, the net foreign savings (i.e. the equivalent of the current account deficit) is set to improve from 11.7% of GDP in 2012 to 8.9% by 2014, mostly due to higher domestic private savings and a decline in the domestic public investment in relation to GDP. Public saving is assumed to remain unchanged. The programme would have benefitted from an in-depth evaluation of the external sector. Projections for key indicators, including export market shares, REER, ULC and NIIP are not provided. An

([7]) See, for example, Çeliku E. and Metani I. (2011) "Competitive position of the Albanian economy in terms of productivity and labour cost", Bank of Albania.

assessment of adequacy of foreign reserves relative to imports and short-term debt and the medium-term external sustainability would have been warranted.

Financial sector

The level of financial intermediation in Albania continued to expand, with banks remaining the dominant sector accounting for some 85% of GDP. All 16 commercial banks are privately owned with the share of foreign ownership standing at some 90% of total assets. Around 73% of the sector's foreign assets are held by EU banks, while Greek and Italian banks represent more than a third of foreign claims, which makes the Albania's banking sector significantly exposed to a potential spill-over in the event that the financial conditions in the EU deteriorate further. Already, a large commercial bank reduced its participation in government securities auctions as an indirect effect of the parent bank's recapitalisation effort has already translated in a higher yield in the 12-month T-bills and lower float on weak demand. The programme acknowledges this risk and notes that contagion risk assessments show that Albania's exposure is higher to Greek than to Italian banks. According to the EFP, credit to the private sector reached 38.6% of GDP in September 2011 - an annual increase of almost 15%. Lending to business remains the major driver of credit growth, rising by around 20% with the bulk going to agriculture and energy (88%). Household credit increased at a more subdued pace of 5.3%, well below historical values. As has been the case in the past, around 69% of the total credit outstanding is foreign-currency denominated of which more than half consist of unhedged loans. Such a high level of foreign currency-denominated loans represents a clear risk as unfavourable exchange rate movements could strain the banks' solvency. On euroisation, the programme acknowledges that the outcome of the measures adopted in the past to reverse this trend have been encouraging but not significant. While the EFP expects that FX-denominated loans will grow at a slower pace, reversing the trend would require additional regulatory action, although it fails to spell them out.

The Albanian banking system is generally well-capitalised and liquid, nevertheless the quality of the loan portfolio has continued to deteriorate. The ratio of liquid assets to short-term liabilities stands at well above the minimum regulatory level of 20%. Deposits which have increased at a fast pace remain a main source of financing, with the credit-to-deposit ratio standing at roughly 60%. The EFP notes that almost all Greek banks have gradually reduced parent bank financing during 2011 and considers their liquidity position as satisfactory. Following a decline in the first half of 2011, the capital adequacy ratio was restored to 15.6% in the fourth quarter, well above the minimum required. Looking forward, the programme expects a stable or a slight increase in the capital adequacy ratio. Non-performing loans (NPLs) for both businesses and households continued to rise during 2011 and stood at 18.9% of total loans in December. The quality of foreign currency denominated NPLs appears to be inferior compared to the lek loans. The banking sector raised provisions for bad loans accordingly which, in turn, had an adverse impact on their profitability. However, the process of execution of collateral has been slow, partly reflecting a weak judicial process, which delays the cleaning up of banks' balance sheets. Going forward, credit risk remains a major cause for concern. A high level of NPLs and tight lending conditions could slow economic growth which, in turn, would create a potential negative feedback loop. Moreover, in the wake of the significant proportion of unhedged FX-denominated loans, a sizeable lek depreciation would make repayments more difficult thereby threatening the stability of the banking sector.

The monetary authorities have taken a number of precautionary initiatives in 2011 to strengthen the stability of the banking sector. In particular, the Banking law was amended giving new powers to the BoA to ask branches of foreign-owned banks operating in Albania to convert into subsidiaries. The law also provides for the establishment of a so-called bridge bank that would facilitate a resolution in the event a bank faces difficulties. In addition, the regulatory and supervisory framework has been enhanced with new and revised rules for credit risk and liquidity risk whereby more conservative regulatory limits, differentiated by currency, on banks' liquidity indicators have been set. The BoA adopts a more prudential approach to Greek banks in terms of capital adequacy and liquidity.

The programme appropriately identifies and discusses the main risks facing the banking sector in a rather comprehensive way. However, the programme would have gained from spelling out the future plans to strengthen the banking sector as well as a better structured presentation.

Main risks to the macro-economic scenario

The macroeconomic scenario presented in the EFP appears to be somewhat optimistic, especially for 2012. The evolution of imports for 2012 seems rather subdued when set against historical import elasticity values and the assumed strong domestic demand. Against this background, the programme's projected achievement of a positive contribution of net exports and a decline in the current account deficit appear rather optimistic.

The main downside risks of the programme's macroeconomic scenario stem from an intensification of the weak economic and financial conditions in the EU and specifically in Albania's main trading partners. Three main channels of transmission are particularly relevant to Albania:

i. the trade and investment channel whereby a further deterioration of external sector may have an adverse impact on private investment and exports, and subsequently on employment, leading to a lower-than-anticipated narrowing of the current account imbalance;

ii. lower-than-expected remittances which represent an important source of current account financing and household income and would adversely affect savings and private consumption, the latter implying lower economic growth since it accounts for some 80% of GDP;

iii. the financial transmission channel in the event that the operation of other local banks are adversely affected by the recapitalisation of parent banks.

In addition, further deterioration of the asset quality of the banking sector and consequently tighter lending conditions could impinge on economic growth. This could, in turn, create a potential negative feedback loop between the banking sector and the real economy. In the event of a further deterioration of external economic conditions and weak investor risk appetite, insufficient capital inflows may lead to a sudden reversal and an abrupt adjustment in domestic demand or reserves. In addition, net exports would be negatively affected in the event of a significant appreciation of the lek against the euro and if the hydroelectricity generating capacity remains impaired by unfavourable weather conditions. Conversely, Albania could benefit from inward investment diversion from the countries in the region hardest-hit by the crisis. The accommodative monetary policy could also prop up economic growth. As the balance of risks is tilted to the downside, output growth might be lower than expected, especially in 2012.

1.5. PUBLIC FINANCE

The main goal outlined in the programme is a consolidation of public finances. Contrary to the previous programmes, the EFP does not spell out the strategy that will be employed to achieve this objective. The consolidation foreseen is rather mild with the budget deficit falling from an estimated 3.5% of GDP in 2011 to 3% in 2012 and 2013 and further to 2.5% by 2014.([8]) After increasing slightly to 59.6% of GDP in 2012, the total public debt-to-GDP ratio is projected to follow a gradual downward path, reaching 59% of GDP in 2014. Although the programme provides sufficient

([8]) Although government finance data are consolidated, they are not in line with ESA 95 methodology.

information on the 2012 budget, it fails to explain in detail the concrete measures that are needed to achieve the planned reduction in the government deficit in the period 2012-14.

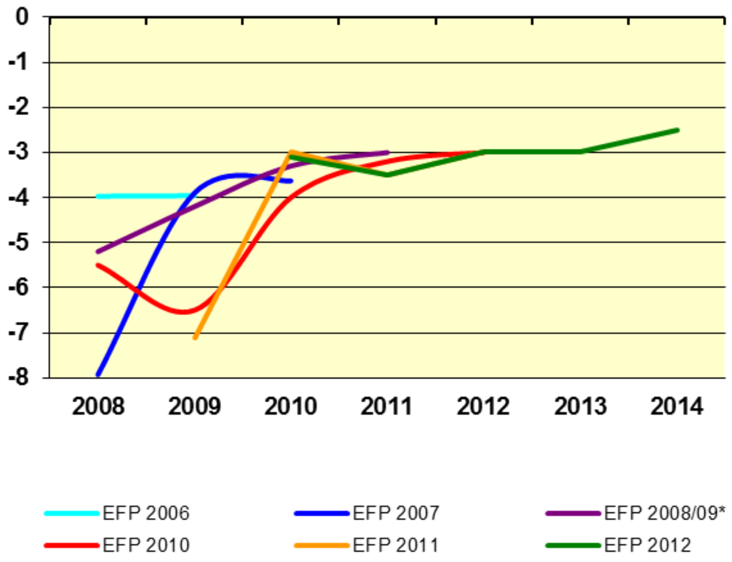
The favourable macroeconomic scenario underlying the budgetary developments makes the fiscal targets appear to be on the optimistic side. The treatment of fiscal risks in the programme is insufficient. The EFP includes a contingency line of some 0.2% of GDP in 2012 to mitigate the risks of a shortfall in the projected revenues and/or to cover any unpredicted emergency expenditures.([9]) It also mentions risks to the public debt arising from interest and exchange rates and re-financing. The EFP does not provide an assessment of the long-term sustainability of public finances.

Budget implementation in 2011

According to the programme, the government deficit is estimated to have reached 3.5% of GDP in 2011 up from 3.1% in 2010. The initial assumption of strong economic growth underlying the 2011 budget has proven overly optimistic with weak revenue performance missing the targets. The planned fiscal deficit of 3.5% of GDP was reached only after mid-year re-balancing of the 2011 budget. Both revenue and expenditure were revised downwards but the deficit target was kept unchanged at 3.5% of GDP.

Total revenue stood at 25.1% of GDP in 2011, a fall of slightly more than 1 percentage point from the previous year. Revenue growth decelerated to 1.8%, reflecting a lower tax yield, especially for direct and indirect taxes, amid weak consumption expenditure, changes in customs and excise duties as well as a sharp fall in non-tax receipts. Total expenditure is estimated to have reached 28.6% of GDP, which is some 0.7 percentage points less than in 2010. In terms of growth, expenditure increased by 3.7% in 2011 following a contraction in the previous year. The rise in spending was primarily due to higher capital outlays which increased by 3.1% and a rise of 6.4% in social transfers.

Graph II.1.2: **Budgetary developments (general government balance, % of GDP)**



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

([9]) Almost all of these funds have already been mobilised to cover the additional costs related to assisting KESH, the electricity operator, to purchase energy.

Medium-term budgetary strategy

On 5 December 2011, the parliament adopted the 2012 budget, which envisages a fiscal deficit of 3% of GDP. The budget assumes real GDP growth of 4.3%, while inflation is projected at 3%. This is in line with the EFP forecasts of the public deficit for 2012.

The programme projects total revenue to increase by 7.7% to 25.7% of GDP in 2012. Total expenditure is set to rise marginally and stand at 28.7% of GDP. Tax revenue is assumed to increase by 6.6% to 18.3% of GDP, due to a higher intake from taxes on production and imports and capital taxes. Indirect tax revenue, which accounts for approximately three-fourths of tax revenue, is planned to rise by slightly more than 6% in 2012. Receipts from VAT, the largest category, are expected to grow by 6.4% which is roughly three times the assumed increase in nominal private consumption and imports. Direct taxes are anticipated to rise by 6.1%, primarily on the strength of a projected increase of 11.5% in profit tax receipts. Although this growth is similar to that attained in 2011, the strong performance was achieved in the wake of buoyant profits by KESH, the electricity operator which benefited from a bumper rainfall which boosted electricity output and exports. Such windfall revenue would be difficult to sustain in the current shortage of rainfall in Albania recorded since the fall of 2011. Social contributions are expected to rise by 5.5% in line with nominal GDP and at a slower pace than a year earlier which appears at odds with the programme's assumed fall in unemployment, the forecasted acceleration in economic output and the authorities' stated policy of reducing the informal economy.([10])

Total expenditure is planned to rise by 5.5% in line with nominal economic growth and stand at 28.7% of GDP in 2012, practically unchanged from the previous year. The higher expenditure is entirely attributed to current spending with interest payments projected to rise by 0.5 percentage points to 3.6% of GDP. Social transfers – the largest expenditure item - are set to increase by almost 7%, partly reflecting government's policy to grant differentiated pension increases (averaging 4% in 2012). Collective consumption, the second largest spending item, is foreseen to rise at a much slower pace than nominal GDP leading to a fall by half a percentage point in 2012. The programme assumes a sharp fall in subsidies which may be challenging to achieve in light of the potential need for further financial support to secure electricity supply. The programme does not discuss the government's payment arrears to construction companies and VAT reimbursements. Capital outlays are assumed to remain at the same levels of the previous year and, expressed as a ratio of GDP, are planned to decline to 5.8% in 2012 from 6.2%.

The programme is based on implicit revenue elasticities for 2012 that are significantly higher than those of the previous year. Apart from a number of commendable initiatives aimed at enhancing the efficiency of the tax administration and combat evasion, the EFP does not provide information on revenue-raising measures which hampers a complete assessment of revenue projections.([11]) In this absence, achieving the revenue projections primarily as a result of economic growth, as the programme seems to assume, does not appear plausible. This, coupled with the significant downside risks stemming from the macroeconomic outlook, suggests that the programme's deficit target of 3% of GDP for 2012 may be overly optimistic. Therefore, achieving the deficit target may necessitate additional spending cuts should revenue underperform. Given Albania's relatively high proportion of non-discretionary spending, potential budget savings would fall on traditionally flexible spending such as capital investment, thereby hampering the growth-enhancing aspect of the public finance strategy.

([10]) The lack of employment projections in the EFP makes a conclusive evaluation difficult.
([11]) The programme fails to report and discuss key fiscal measures such as the budgetary impact of the tax amnesty.

Table II.1.2:

Composition of the budgetary adjustment (% of GDP)

	2010	2011	2012	2013	2014	Change: 2011-14
Revenue	26.2	25.1	25.7	25.7	25.8	0.7
- Taxes and social security contributions	22.4	22.3	22.5	22.7	22.9	0.6
- Other (residual)	3.8	2.8	3.2	3.0	2.9	0.1
Expenditure	29.3	28.6	28.7	28.6	28.3	-0.3
- Primary expenditure	25.9	25.5	25.1	25.0	24.7	-0.8
of which:						
Gross fixed capital formation	6.3	6.2	5.8	5.7	5.3	-0.9
Consumption	9.6	9.0	8.5	8.4	8.3	-0.7
Transfers & subsidies	10.2	10.3	10.2	10.2	10.2	-0.1
Other (residual)	-0.2	0.0	0.6	0.7	0.9	0.9
- Interest payments	3.4	3.1	3.6	3.6	3.6	0.5
Budget balance	-3.1	-3.5	-3.0	-2.9	-2.5	1.0
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	0.3	-0.4	0.6	0.7	1.1	1.5
Gross debt level	54.1	55.2	55.4	55.1	54.3	-0.9

Sources: Economic and Fiscal Programme (EFP) 2012, ECFIN calculations

The programme envisages a continuation of budgetary consolidation over the medium term with the fiscal deficit projected to stabilise at 3% in 2013 and fall to 2.5% of GDP by 2014. This is planned to be achieved by lowering the total expenditure ratio in 2014, while total revenue is anticipated to remain practically unchanged. In 2014, total expenditure is set to reach 28.3% GDP, mostly on the back of lower public investment outlays which are assumed to average 5.5% of GDP annually in 2013-14. Current spending is foreseen to remain almost unchanged at 23% of GDP over the programme horizon as the increase in the other expenditure component is mostly neutralised by a decline in collective consumption. The EFP does not quantify the impact of wage and pension increases in the outer years, neither on the annual budgets, nor on the long-run sustainability of public finances. In addition, parliamentary elections will be held in 2013 which, as past experience has shown, is normally characterised by a weak tax intake and higher spending. Total revenue is projected to remain practically unchanged in 2013 and rise marginally to 25.8% of GDP by the end of the programme period.([12]) The EFP anticipates that tax receipts increase at a faster pace than nominal GDP growth in 2013 and 2014, suggesting relatively high implicit assumptions as regards tax elasticities for these years.

To sum up, the programme's budgetary projections could turn out to be difficult to achieve due to a number of risks which on balance appear to be on the downside and which the EFP does not appropriately address. The downside risks relate to the favourable macroeconomic scenario and the relatively high tax elasticities underpinning the fiscal scenario which make revenue projections appear optimistic. Although providing some buffer, the contingency line of 0.2% of GDP in 2012 which has almost been already exhausted, may not be sufficient in the face of underperforming revenues and/or expenditure slippage. The accumulated VAT reimbursements and payment arrears is another risk as is the implementation of a deal to net-off arrears of electricity bills owed by certain public agencies to CEZ, the electricity distributor and outstanding receivables owed to KESH, the producer and importer

([12]) Although not explicitly stated in the programme, projections for tax revenue appear to be based on a no-policy change assumption.

of electricity. Higher interest payments, should yields continue to rise as a result of the commercial banks' reduced participation in government securities, could pose a risk to fiscal consolidation. For 2013, revenue and spending may underperform in view of the heightened spending pressures ahead of the 2013 parliamentary elections. Lastly, the reliance of budgetary consolidation on lower public investment appears to be ambitious in view of possible cost overruns notorious with capital projects. The lack of information on the measures underpinning the consolidation is also a downside risk.

Budgetary implications of "major structural reforms"

The budgetary impact of structural reforms is treated only very partially in the EFP since the requested matrix on policy commitments is not provided. The programme mentions the continuation of the process for the review of organisational structures of line ministries and budgetary institutions as a major structural reform. The objective of this reform is to enhance the effectiveness and efficiency of public administration through, amongst others, downsizing. The total budgetary impact of this reform is estimated to amount to Lek 100-150 million, while the programme does not specify the period over which these savings will be realised. Another reform is aimed at the social security system. The programme acknowledges the need to improve the financial sustainability of the old-age pension system in the medium term but does not provide details of the reforms to attain this objective. Social assistance recipients will be better targeted by linking benefits to employment and family status. The EFP notes that the reforms to the assistance programme will broaden their coverage and increase the benefits. Similar changes are also envisaged for disability entitlements. The EFP does not provide estimates of the budgetary impact of these reforms and is not clear on government's plans to tackle the funding gap in the state pension system which is expected to widen in the coming years, especially in the context of an ageing population.

General government debt

According to the programme, government debt-to-GDP ratio stood at 58.9% in 2011, representing an increase from 57.8% recorded in the previous year. Around 57% of total public debt is domestically-owned, of which some 85% is held by the banking sector. Foreign debt is mostly euro-denominated, while the proportion of debt on concessional terms continued to decrease and be replaced by commercial loans.

Net of guarantees, government debt rose by slightly more than 1 percentage point to 55.2% of GDP in 2011. The reversal in the debt trajectory was primarily due a higher primary deficit which contributed to 0.4 percentage points of GDP as well as unfavourable stock-flow adjustments which added around 0.8 percentage points to the debt ratio, partly reflecting the depreciation of the lek against the euro. The EFP projects a peak in the debt ratio in 2012, and a gradual decline until the end of the programme period.

Table II.1.3:

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

	2010	2011	2012	2013	2014
Gross debt ratio [1]	**54.1**	**55.2**	**55.4**	**55.1**	**54.3**
Change in the ratio	-1.2	1.1	0.1	-0.3	-0.7
Contributions [2]:					
1. Primary balance	**-0.3**	**0.4**	**-0.6**	**-0.7**	**-1.1**
2. "Snow-ball" effect	**3.4**	**0.0**	**0.7**	**0.4**	**0.4**
Of which:					
Interest expenditure	3.4	3.1	3.6	3.6	3.6
Growth effect	0.0	-3.4	-3.9	-3.2	-3.2
Inflation effect	0.0	0.2	1.1	-0.1	0.0
3. Stock-flow	**-0.4**	**0.8**	**0.1**	**0.0**	**0.0**

Notes:

[1] End of period.

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

Source: Economic and Fiscal Programme (EFP) 2012, Commission services' calculations

In 2012, the debt-to-GDP ratio is expected to reach 55.4% before falling to 55.1% and 54.3% of GDP in 2013 and 2014, respectively. For 2012, the positive impact of the primary budget surplus on the debt ratio is more than outweighed by the slower nominal GDP growth. The downward trend in the debt ratio projected in the outer years is driven by a further increase in the primary surplus as well as an acceleration of nominal GDP growth. Stock-flow adjustments are assumed to be negligible. The programme's fiscal projections do not include privatisation proceeds, although they are discussed in the structural reforms section of the document. While this is a below-the-line item, indicative amounts would have been welcome in view of the considerable refinancing needs of public debt. In addition, their inclusion would have enhanced consistency within the document. The programme's projected reduction in the debt ratio is back-loaded with the bulk of the decline occurring in 2014. The programme envisages a slower pace of decline in the public debt compared to that foreseen in last year's EFP. Notwithstanding the favourable macro-fiscal scenario presented in the programme, the reduction in the public debt is expected to be modest.

The EFP highlights a number of risks to the evolution of the public debt, notably the volatile global economic and financial conditions, the short-term bias of the debt structure which gives rise to roll-over risk as well as those stemming from fluctuations in the interest rate and the exchange rate. In addition to the baseline scenario, the programme presents an alternative scenario by assuming lower growth, a depreciation of the lek and an increase of 100 basis points in interest rates over the medium term. The results obtained from this alterative scenario show that the aggregate impact of the shocks would increase the total public debt ratio above the statutory 60% of GDP ceiling in 2012, with further increases in years 2013-2014.

This underscores the downside risks surrounding the debt trajectory envisaged by the programme, in the event of unexpected developments. Given the substantial size of Albania's public debt and the current uncertain global economic outlook, lower-than-projected GDP growth would further limit the fiscal space and jeopardise the sustainability of public finances. This becomes even more relevant in the context of a rising share of debt on commercial terms. Similarly, as Albania seeks external borrowing, the exchange rate risk will assume increasing importance on the evolution of debt. As parent banks seek to repair their balance sheets, the reliance on commercial banks as holders of government debt poses an additional downside risk. On the upside, government debt could be lower-than-projected should the planned privatisation, especially the hydro-generating plants, be carried out. The alterative scenario presented in the programme would benefit from a more comprehensive discussion of the impact of the individual shock variables on the debt trajectory. In line with the arguments discussed in the previous sections, a slower GDP growth than projected in the programme would result in lower tax revenue, a worse fiscal imbalance and thereby a higher public debt-to-GDP ratio.

Quality of public finance and institutional features

The programme's analysis of the quality of public finances is limited and focuses mostly on past developments in fiscal decentralisation to local governments. Albania's tax structure remains oriented towards indirect taxes, which account for some 70% of total tax revenue and are projected to remain at this level over the programme period. The income tax system is characterised by a flat rate of 10%. Public spending is to some extent conducive to growth. Around a fifth of total expenditure is devoted to public investment, while subsidies are low and declining. Within public investment, health, education, infrastructure and agriculture remain priority areas.

Still, there is considerable scope for improving the quality of public finance. Government consumption expenditure and social transfers constitute around 65% of total spending. The share of interest payments stands at roughly 11% of total expenditure and is projected to rise over the programme horizon. Re-directing additional expenditure towards growth-promoting categories, such as education, human capital and productive physical infrastructure would enhance long-term growth. Moreover, in the face of limited budgetary resources and competing spending needs, it is important to shield these expenditure categories. In recent years, capital outlays were the main spending category to suffer cuts when mid-year budget re-balancing became necessary. Safeguarding growth-enhancing spending categories could be achieved through the reduction of public debt as the resulting lower interest payments would free resources for other uses as well as by ensuring that tax revenue reaches its potential level.([13]) The programme spells out a number of ongoing initiatives aimed at improving tax compliance through measures that deter and investigate evasion as well as improving the effectiveness of the tax and customs authorities. As to institutional features, the laws concerning public financial control measures are still not fully implemented and need to be strengthened further. A medium term project is underway aimed at developing a treasury system which when fully operational should enhance budgetary execution and oversight.

Although significant progress has been achieved along the years, an important area which would benefit the budgetary process is to ensure more realistic revenue projections and the macroeconomic framework underpinning them. An overestimation of the GDP growth trajectory in the medium-term results in revenue undershooting the targets and hence underestimate future fiscal deficit. As has happened in the past years, this leads to unwarranted fiscal policy responses and mid-year adjustments that usually target capital spending. Such responses and adjustments are costly as they disrupt investment programmes, distort spending choices of ministries and reduce the predictability of policy which is viewed unfavourably by investors. The programme does not provide information on the government's plans to adopt the ESA95 methodology.

([13]) For example, revenue raised by local government remains significantly weak with the actual receipts collected being some 20% less than budgeted in 2011.

1.6. STRUCTURAL REFORMS

Obstacles to growth and the structural reform agenda

The EFP does not identify the structural obstacles facing Albania's economic growth as a basis for the formulation of a comprehensive and targeted structural reform strategy. It focuses on short term risks stemming from the deterioration in the external environment, in particular in its main EU economic partners.

The main impediments considered to be essential to address include the further improvement in the business climate by dealing with significant shortcomings regarding access to finance, public administration and the legal system, the delay in issuing building permits as well as putting in place orderly market exit procedures. Action is also needed in finding a lasting resolution to the issue of property rights, the enforceability of contracts and the rule of law as well as tackling the informal economy. It is important to strengthen infrastructure, especially energy and transport, as well as human capital by improving the education system and upgrading the skills of the labour force, as well as improving the functioning of the labour market.

Key areas of structural reform

Although some progress was achieved, the EFP's review of structural reforms is still largely backward-looking while information gaps on key areas remain. The programme could have benefitted from more clarity and details when outlining future plans. Specifically, initiatives to attract FDI, reforms to strengthen further the energy sector and steps to enhance the functioning of the labour market are not fully tackled in the programme. Moreover, the link with the fiscal framework is not apparent, a clear timetable for the implementation of the reforms is missing while the budgetary impact of the measures is not quantified. The main risks to the implementation of structural reforms relate to the issue of enforcing property rights which continues to hamper the attraction of investment, further delays in the privatisation process and the still-fragile domestic political situation which makes the implementation of reforms more challenging.

Product and capital markets

Reforms aimed at improving the business climate were less far-reaching in 2011, although some progress was recorded. Notable achievements include the further reduction of time and steps needed to start a business (5 days down from 36 days in 2010 and 5 steps from 10 in the previous year) and the approval of the law reforming the inspection system. Although as in previous programmes, the EFP underlines the ongoing preparatory work for the privatisation of Albpetrol, Albtelecom, Armo and four hydroelectric plants, implementation is still lagging behind. Additional concessions were granted for the operation of small private hydro power plants, although the completion of other plants is delayed mainly due to difficulties with the issuing of construction permits. In general, the procedures involved in granting building permits remain lengthy, delaying the revival of the ailing construction sector. Access to finance remains a major obstacle to business as limitations persist in terms of availability and affordability of capital. Despite the establishment of the Bankruptcy Supervisory Agency, the implementation of bankruptcy laws remains ineffective. The programme could have laid more emphasis on measures in support of attracting green-field FDI. In this context, the EFP fails to provide concrete plans to address the long-standing issue of property rights which remain a cause for concern. The business community continues to face delays in court procedures, weak enforcement of contracts and execution of collateral. Informal methods of contract enforcement, by-passing the legal system, continue to be widespread. Notwithstanding the establishment of the private bailiff office, training and administrative capacity remain weak which hampers the process of collateral execution. The lack of political consensus continues to delay the setting up of the administrative court. There is a lack of scientific research institutions and weak collaboration between universities and industry on R&D. Regrettably, the EFP does not discuss the government's plans in the telecommunications sector in which Albania displays weaknesses.

Labour market

Compared to previous programmes, the EFP takes a somewhat more forward looking approach to the labour market section, with the main strategic objective being the modernisation of the national employment service. Still, no attempt is made to evaluate the major challenges facing the labour market, while reforms are not spelled out in detail. The information provided mainly consists of a description of measures that have been in place for a number of years. The high inactivity rate points to Albania's huge potential in boosting economic growth by encouraging more people to enter the labour force. Despite several initiatives in the past, including a reduction in social contributions, informal work arrangements remain widespread across most economic activities. Unemployment has remained persistently high while long-term unemployment accounts for around 75% of total jobseekers. Reducing such structural unemployment will be challenging even at times of strong growth, especially in view of the age structure and the prevailing skills mis-matches. Other structural rigidities, such as redundancy costs may also hamper the functioning of the labour market. Despite that education is a priority sector, shortages of qualified employees persist as a result of deficiencies in the education and skills system. Linked to this is the challenge of stemming the brain drain. The EFP does not discuss these issues. The programme does not provide data on the expected evolution of the labour market, including wages, which is regrettable and should be rectified in the future.

Other reform areas

The effective implementation of public administration reform remains weak. Although relevant laws have been drafted, they are still not adopted due to a lack of qualified parliamentary majority. In addition, the public administration remains hampered by shortcomings in respect of temporary contracts used to circumvent selection procedures and the dismissal of civil servants outside legal procedures. On compensation, the plans for the next years include linking the salary with employees' evaluation and training as well as indexing of salaries. It is important to ensure consistency between the wage setting process in the public sector and the BoA's inflation target in order to safeguard the overall policy-mix. The EFP also highlights reforms in the railway system which should eventually open the market for more competition. A law has been drafted providing for a separation of the state-owned entity into four separate companies and the establishment of the sector's regulatory authority in the medium term.

Although the programme makes an effort to list future plans, in most cases it remains relatively vague with respect to concrete measures over the programme horizon. For most reform areas, the programme does not establish a strategic link to the government's growth objectives and neither quantifies the budgetary costs of reform measures outlined. Moreover, the conceptual and operational link of the reform areas with the EU accession process notably the European Partnership is rather limited.

1.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

While an improvement can be observed in certain aspects, the 2012 EFP lacks coherence in its presentation and would benefit from a more co-ordinated approach in its preparation. Ample scope exists in making it more structured and well-balanced while ensuring ownership by the relevant stakeholders and raising its profile as a key strategy document with the domestic and foreign audience.

Macro framework

Although more realistic compared to the previous programme, the macroeconomic scenario presented in the 2012 EFP remains optimistic especially in view of the volatile economic and financial conditions in Albania's trading partners. The programme does not provide alternative macro scenarios while risks are not given due consideration. Almost all the relevant data are covered but weaknesses remain, in particular, as regards labour market and wage statistics. In describing the past economic developments, the document would have benefitted from more clarity, while plans are not always spelled out.

Fiscal framework

While broadly comprehensive, the fiscal framework lacks coherence with the medium-term economic outlook. In particular, tax elasticities generate revenue projections which are more favourable than what the assumed economic developments would suggest. Key fiscal measures for 2012 are not described comprehensively. The EFP would benefit from more concrete information on the envisaged fiscal policy measures in the medium-term and their budgetary impact. The fiscal framework addresses European Partnership priorities, such as implementing a stability-oriented fiscal policy by pursuing fiscal consolidation, without however explicitly referring to them.

Structural reforms

The EFP does not identify the structural obstacles facing Albania's economic growth. The treatment of structural reforms remains relatively lengthy, largely descriptive and backward-looking. It remains vague on the overall strategy while the link between the reforms and the fiscal objectives is not obvious. The document does not contain a matrix of policy commitments and does not feature any policy priorities, while it lacks a quantification of the budgetary impact of the measures.

* * *

2. BOSNIA AND HERZEGOVINA

2.1. SUMMARY AND CONCLUSIONS

Bosnia and Herzegovina submitted its 2012 Economic and Fiscal Programme (2012 EFP), covering the period 2012-2014, on 21 March. Its preparation has been hampered by the prolonged process of government formation at the state level and the lack of a medium-term fiscal strategy. The programme is not integrated into the country's budgetary procedure. Its overarching objectives and the means to achieve them remain unclear. While it broadly complies with the required content and form, it disposes of several weaknesses, such as fiscal inconsistencies and data gaps.

The economic recovery gained momentum in 2011, driven by domestic demand. The EFP estimates real GDP growth to have reached 2.4% in 2011. External imbalances started to rise again and the current account deficit soared to 8.4% of GDP, mainly due to imports expansion, fuelled by rising private consumption and investment demand. Inflation accelerated to 3.7%, reflecting the evolution of international prices of commodities. The EFP projects real GDP growth to moderate slightly in 2012 before it accelerates gradually, reaching 4.8% in 2014. The recovery will be mainly domestic demand-driven, while exports will also rise at solid rates towards the end of the programming period. Given the high uncertainty and worsened growth outlook in the EU, the programme's 2012-2014 growth scenario appears optimistic.

According to the EFP, the consolidated budget deficit has reached 1.3% of GDP in 2011, which is below both the 2010 outcome and the previous year's EFP target of 2.2%. The observed fiscal consolidation was achieved as a result of rising revenues, fuelled by the economic recovery, while expenditures fell slightly but their structure further deteriorated due to shrinking capital spending. The programme aims at an expenditure-led fiscal consolidation of 2.4 percentage points of GDP by 2014, but does not provide information on the medium-term fiscal stance and on measures underlying the required adjustments on the spending side, thus impeding the assessment of the plausibility of the fiscal programme. The fiscal scenario also does not appear to be consistent with the macroeconomic projections. Some possible fiscal risks are mentioned on the revenue side, while the programme remains silent about significant fiscal risks on the expenditure side e.g. that the cuts foreseen in current spending may not be implemented to the planned extent or that some unforeseen spending rise might appear in the election years (2012, 2014).

The programme does not comply with the Commission's requirement to present an overall assessment of the medium-term sustainability of the country's external position. Bosnia and Herzegovina's current account deficit contracted sharply in 2009-2010 in a crisis-led adjustment, initially driven by shrinking imports, due to falling domestic demand, and thereafter by the favourable evolution of metal prices, fuelling nominal export growth. However, the process of improvement of the current account deficit has been reversed since mid-2010 and external imbalances have started to grow again. The EFP foresees that – due to a persistently rising foreign trade gap – the current account deficit will widen to about 10% of GDP in 2014, while the net capital inflows – though rising – will be insufficient to finance it. The projected trajectory of the current account balance suggests a continuation of the same vulnerable and unsustainable growth model, which prevailed in the pre-crisis period, i.e. externally financed high domestic consumption, accompanied by large current account deficits and low domestic savings. Against a background of low investors' risk appetite, uncertainty and global financial turbulences, relying on this model could result in an unsustainable, sharp decline of the foreign exchange reserves.

The EFP does not describe the main structural obstacles to growth, as requested by the Commission. A stronger economic performance in Bosnia and Herzegovina is mainly impeded by: i) a large government sector, characterised by low spending efficiency and sizeable interference in the economy, which distorts market signals; ii) an unfavourable business environment, which hampers private sector development; iii) low quality of the human capital, combined with a dysfunctional labour market; iv) low production capacity and export base. The structural reform agenda presented in the 2012 EFP is vague and lacks an overall strategy, presented in a comprehensive and coherent manner. There is significant room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation.

The main risks to the programme are related to a higher-than-expected deterioration of the external environment – which would undermine exports' performance, while lowering current transfers and net capital inflows –, and political resistance against the intended current spending cuts and overall fiscal consolidation, given the country's track record in the implementation of unpopular reforms.

The programme's reform agenda is insufficiently linked to the fiscal scenario and only partly aligned with the reform requirements in view of the country's European Partnership priorities, findings of the Progress Report and the implementation of the Stabilisation and Association Agreement.

2.2. INTRODUCTION

The 2012 EFP of Bosnia and Herzegovina, covering the period 2012-2014, was submitted to the Commission on 21 March 2012, well after the expiry of the set deadline. The significant delay has been caused – among other factors – by the prolonged political stalemate in the country. The programme was adopted by the newly formed Council of Ministers of Bosnia and Herzegovina. It is not integrated into the budgetary procedure.

The programme is an update of the 2011 EFP. Like in previous years, the programme would have benefited from establishing a closer link to the country's accession process, such as the assessments in the European Commission's Progress Reports and priorities defined in the European Partnership documents.

2.3. KEY POLICY CHALLENGES

The main policy challenge Bosnia and Herzegovina faces is to create conditions for sustainable economic growth. Efforts need to be strengthened for improving the business environment, addressing the deficiencies in the functioning of the labour market, raising the quality of the human capital and of the basic infrastructure, thus establishing an adequate basis for faster private sector development and strengthening the economy's competitiveness and growth potential. In the context of rather limited availability of monetary policy tools, the onus falls on fiscal policy. Thus, significant efforts are needed for improving the structure, quality and long-term sustainability of public finances.

The country faces a number of challenges on its path towards EU accession that are described in the European Partnership priorities and the Progress Reports. In particular, Bosnia and Herzegovina needs to continue fiscal consolidation and step up its efforts in a number of structural reform areas, such as the privatisation process in the Federation, the pension system, the system of social benefits, law enforcement, as well as the production of reliable economic statistics.

2.4. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

Recent macroeconomic developments

The economic recovery, which started in 2010 with a real GDP growth of 1%, accelerated slightly in the course of 2011 and GDP growth reached 2.4%, according to the EFP estimates([14]). Unlike the previous year, when external demand was the main engine of growth, in 2011 domestic demand recovered – supported by a stable inflow of remittances and an accelerating credit growth – thus fuelling faster economic expansion. According to the EFP estimates, private consumption, which accounts for 79% of GDP, rose by 3%, as compared to a -1% decline in 2010. Gross fixed capital formation, accounting for slightly over 1/5 of GDP, soared by 9.7% (after falling by -11.1% a year earlier). The recovery of domestic demand boosted import growth which, combined with a significant moderation of exports' expansion, resulted in a widening trade deficit. Dominated by trade developments, the current account deficit soared by 80.9%, reaching 8.4% of GDP in 2011, after the registered improvements in the previous two years. Despite the economic recovery, unemployment increased throughout 2011, due to some labour shedding in the private sector. Annual inflation accelerated slightly to 3.7%([15]), up from 2.1% in the previous year. The acceleration of the consumer

([14]) Note that expenditure-side GDP data are used in the EFP, which are higher than the usually used production-side GDP data. Therefore, GDP-related figures have a downward bias in the EFP.
([15]) According to the latest data published by the Statistical Agency. The EFP estimates 2011 inflation at 4.0%.

prices growth was mainly a result of the evolution of international food and oil prices, while inflation was also driven by a hike in excise duties on tobacco.

The description of macroeconomic developments in 2011 in the EFP is broadly realistic, although GDP growth might be slightly overestimated. Where final data is not yet available, the EFP relies on assumptions based on available data for parts of the year.

Table II.2.1:

Macroeconomic developments

	2010	2011	2012	2013	2014
Real GDP (% change)	1.0	2.4	2.1	4.0	4.8
Contributions:					
- Final domestic demand	-2.8	4.3	4.3	5.6	6.3
- Change in inventories	0.7	0.0	0.0	0.0	0.0
- External balance of goods and services	3.1	-1.9	-2.3	-1.6	-1.6
Employment (% change)	-1.9	-3.2	-0.1	1.6	2.1
Unemployment rate (%) LFS	27.2	27.6	27.9	27.4	25.8
GDP deflator (% change)	-0.8	2.1	2.7	2.6	3.0
CPI inflation (%)	2.1	4.0	1.9	1.8	1.6
Current account balance (% of GDP)	-4.9	-8.4	-9.6	-10.0	-9.9

Sources: Economic and Fiscal Programme (EFP) 2012

Medium-term macroeconomic scenario

The EFP presents a medium-term macroeconomic scenario, based on the assumptions of the Commission's autumn forecast as regards the external environment. It projects a slight GDP growth moderation to 2.1% in 2012 and a higher, mainly domestic demand-driven, growth of 4.0% in 2013 and 4.8% in 2014. The rising external demand is expected to trigger faster expansion of the export-oriented branches of the processing industry. The labour market will be positively influenced by the higher economic activity and employment will rise. The gradually accelerating private consumption and investment demand will be accompanied by rising imports and thus the foreign trade deficit will rise, triggering a widening current account deficit, reaching about 10% of GDP in 2014. FDI is expected to pick up on the back of some major projects in the energy sector and relaunched privatisation in the Federation. Still, the net capital inflows are projected to lag behind the current account deficit, thereby foreign exchange reserves are to decline in 2012-2013 and only partially recover in 2014. Inflation rates are expected to follow a downward trend, mainly influenced by international prices.

Overall, the described medium-term macroeconomic scenario is optimistic in the context of the worsened growth expectations for the EU([16]). In a marked improvement to the previous programme, the 2012 EFP presents a description of some risks to the macroeconomic scenario. The programme

([16]) The authorities revised downwards their forecast in April with GDP growth projected at 0.9% in 2012, 2.1% in 2013, and 3.5% in 2014, which appears to be more realistic. The assessment of the medium-term macroeconomic scenario is based on the projections as provided in the 2012 EFP.

would have benefited from elaborating alternative macroeconomic scenarios in the context of the identified significant downside risks.

Real sector

According to the EFP, the economy will be negatively affected by the worsening international environment in 2012 and GDP growth will moderate – though only marginally –, while afterwards strong economic growth will occur. From the demand side, it is assumed that investments will play a crucial role in the expected economic expansion, while private consumption will also remain a key growth contributor, as it was in the pre-crisis period. The scenario assumes that the share of government consumption expenditures in GDP will increase in 2012, which is in contradiction to the targeted fiscal consolidation. Afterwards, the growth of government consumption is projected to fall behind GDP growth, thus allowing for some fiscal consolidation. Following a temporary moderation in 2012, exports are expected to expand at solid rates (8-9% in real terms) in 2013-2014, based on a strengthened economic growth in the region and in the EU (i.e. the country's main exports markets). Still, the net contribution of the external sector to the economic growth is projected to be negative during the whole programming period, due to simultaneous faster imports' rise, triggered by growing domestic demand. From the supply side, it is expected that the recovery of export markets will influence positively the processing industry in Bosnia and Herzegovina, in particular the metal, chemical, and wood processing industries. Construction sector will also expand, driven by infrastructure projects. Employment is expected to grow from 2013 onwards. Subsequently, the unemployment rate is expected to fall after a peak in 2012, though it will remain persistently high. Labour productivity (as measured by real GDP per person employed) is set to grow by 2-3% until 2014.

Inflation

Given that Bosnia and Herzegovina's economy is relatively small and open with a rather high degree of price liberalisation([17]), inflation is strongly influenced by international price developments, especially of oil and food. Average annual inflation in 2011 reached 3.7%, reflecting the upward trend of food commodities and energy prices on the global markets, as well as the increase of excise duties on tobacco in Bosnia and Herzegovina. Afterwards, the inflation rate is expected to gradually decelerate from 1.9% in 2012 to 1.6% in 2014. The inflation scenario might be slightly optimistic given the rising oil prices in early 2012. Moreover, it is subject to upside risks due to the non-negligible increase of domestic demand projected for 2013-2014.

Monetary and exchange rate policy

Bosnia and Herzegovina continues to operate a Currency Board Arrangement – with the convertible mark fixed to the euro which has worked well as a stabilising monetary anchor, as further evidenced in the global economic crisis. There is a wide consensus in favour of keeping this arrangement. The Central Bank of Bosnia and Herzegovina increased the liquidity of the banking system by lowering the minimum reserve requirement rate for short-term deposits from 14% to 10% as of February 2011. As the nominal exchange rate is fixed against the euro, the evolution of the real exchange rate is determined by the inflation differential vis-à-vis the euro area. By projecting (slightly) higher inflation, the programme implicitly assumes a (marginal) appreciation of the real exchange rate against the euro.

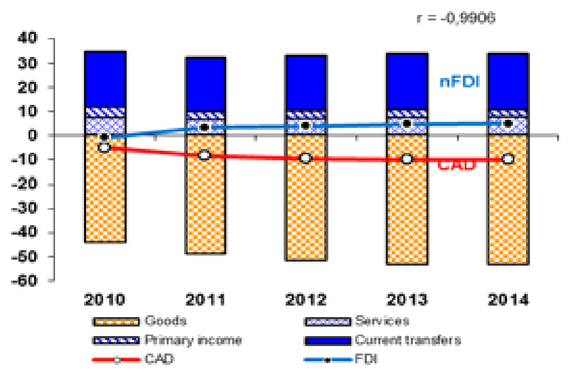
([17]) Most prices are liberalised, even though a number of administrative prices remain (e.g. for utilities).

External sector

The EFP does not comply with the Commission's requirement to present an overall assessment of the medium-term sustainability of the country's external position. Bosnia and Herzegovina's current account deficit contracted sharply from 12.3% of GDP in 2008 to 4.9% in 2010([18]) in a crisis-led adjustment, initially driven by shrinking imports, due to falling domestic demand, and thereafter by the favourable evolution of metal prices, fuelling nominal export growth. However, the process of improvement of the current account deficit has been reversed since mid-2010 and external imbalances have started to grow again. According to the EFP, the current account deficit soared by 80.9% to 8.4% of GDP in 2011, mainly due to the expansion of the trade gap. For the rest of the programming period, the foreign trade deficit is projected to continue increasing, so that the current account deficit will widen to 10.0% of GDP in 2014. While the foreseen imports' path is in line with the projected growth of domestic demand, the projected exports' performance towards the end of the programming period appears optimistic, given the narrow export base. The projected trajectory of the current account balance suggests a continuation of the same growth model, which prevailed in the pre-crisis period, i.e. externally financed high domestic consumption, accompanied by large current account deficits and low domestic savings. However, such model – while vulnerable and unsustainable in the first place – depends exclusively on capital inflows, which the country might not be able to attract in the current environment of uncertainty and global financial turbulences.

According to the EFP, FDI will increase and reach EUR 1-1.4 billion in 2012-2014, partly due to the relaunched privatisation process in the Federation, but mainly under the form of greenfield investments in the energy sector. FDI inflows are expected to cover between 1/5 and 1/4 of the current account deficit. Other capital inflows are projected also to rise over the programming horizon, but still net capital inflows will be lower than the current account deficit. Thus foreign exchange reserves are set to decline sharply by 12.7%([19]) in 2012-2013, and to only partially recover in 2014. The EFP claims that the falling reserves will not jeopardise the stability of the Currency Board Arrangement. However, given its magnitude, the projected loss in reserves could potentially impact on macroeconomic and financial stability and thus requires careful attention and the development of policy measures on the part of the authorities. While FDI projections are more cautious than in previous years, they appear still somewhat optimistic, given the privatisation process track record and uncertain global economic environment.

Graph II.1.1: Evolution of the current account
(in % GDP)



([18]) Annex table 1g presents different current account-to-GDP ratios, but seems to use production-side GDP data while the EFP explicitly states that expenditure-side GDP are used in the programme.
([19]) Own calculations, based on data from the Central Bank of Bosnia and Herzegovina on the level of gross foreign reserves at end-2011 and EFP projections for change of reserve assets in 2012-2013

Financial sector

The financial sector is dominated by banks. Banks with foreign ownership accounted for approximately 90% of the total banking system assets in 2011. The share of claims on the private sector in relation to GDP decreased marginally to around 48%([20]) at end-2011, on the back of decelerating bank lending to the private enterprises, which has been only partially offset by some recovery of credits to the household sector. The capital adequacy ratio of the banking system stood at 17.2%([21]) at the end of 2011, comfortably above the legal minimum of 12%. However, the deterioration in the quality of bank assets is an issue of concern with the share of non-performing loans to total loans reaching 11.8% at end-2011.

The EFP projects a gradual acceleration of the credit growth, reaching 15% in 2014, thus supporting faster economic expansion. At the same time, annual deposit growth is estimated to continuously lag behind and the loan-to-deposit ratio – reaching 117.8% at end-2011([22]) – to further increase, thereby implicitly assuming that the banking sector will keep its growth model, based on foreign financing (mainly from the parent banks), which however might be difficult to achieve, having in mind the deleveraging pressures in the EU banks. Risks are clearly on the downside, especially in the light of the sovereign debt crisis in the EU.

Main risks to the macroeconomic scenario

For the first time the 2012 EFP describes some possible downside risks to the macroeconomic scenario, which is a welcome improvement. Risks stem especially from the potential deterioration of the international and EU economic environment and the evolution of international prices for commodities. In addition to the few domestic risks mentioned in the EFP, political risks should not be underestimated, although the long-lasting political stalemate seems to have been resolved in early 2012. The programme would have benefited from presenting alternative scenarios, based on the identified downside risks.

2.5. PUBLIC FINANCE

The 2012 EFP fails to present a convincing overall fiscal strategy, which is hardly surprising given the fact that it was elaborated in the context of lacking medium-term fiscal framework at the country level. The programme foresees a predominantly expenditure-led fiscal consolidation, aiming to improve the general government balance by 2.4 percentage points of GDP – from a budget deficit, accounting to 1.3% of GDP in 2011, to a surplus of 1.1% of GDP in 2014. However, the EFP lacks a comprehensive description of medium-term measures and policy actions beyond 2012, which would support such an adjustment. The projected adjustment of the overall expenditures seems to be overly ambitious, while the projected dynamics of revenues is surprisingly cautious and not in line with the presented macroeconomic scenario.

For a second consecutive year already, the EFP presents a comprehensive overview and projection of both domestic and external public debt. In line with the projected gradual fiscal consolidation, public debt is expected to follow a downward path, from 32.9% of GDP in 2011 to 26.2% of GDP at the end of the programme horizon.

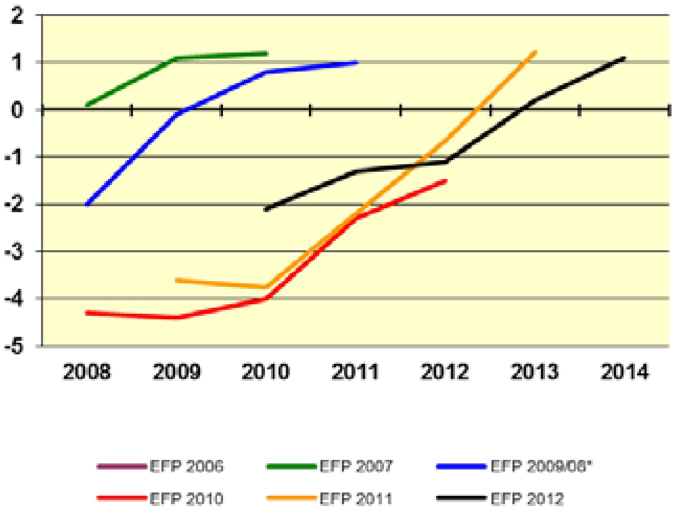
([20]) According to latest data published by the Central Bank of Bosnia and Herzegovina.
([21]) According to latest data published by the Central Bank of Bosnia and Herzegovina.
([22]) According to latest data published by the Central Bank of Bosnia and Herzegovina.

Budget implementation in 2011

The 2012 EFP provides scarce information as regards budgetary developments in 2011. According to the data presented in the annex, the general government deficit accounted for 1.3% of GDP. Official budget reports have not been published by the time of drafting this assessment. According to a recent release of the Macroeconomic Analysis Unit of the Indirect Tax Authority, consolidated revenues increased by 2.5% in 2011. Indirect taxes, accounting for 43.9%([23]) of the overall revenues, rose by 2.9%, positively influenced by the economic recovery and increased excise duties on tobacco, while negatively affected by the further reduction of tariffs, as foreseen by the Interim Agreement on trade with the EU. Collected contributions increased by 4.1%, partly because of the increased contribution rates in the Republika Srpska. Consolidated expenditures fell by -1.6%, mainly due to the contraction of capital spending (-31.4%) and purchases of goods and services (-20.2%). At the same time, the wage bill and expenditures for subsidies and transfers (mainly social benefits) expanded by 5% and 14%, accounting for 29% and 44.4% of the overall expenditures, respectively. The higher wage bill was partly caused by the income tax changes in the Republika Srpska as of February 2011. Overall, the fiscal consolidation was achieved at the expense of public finances quality which further deteriorated as the capital spending served as a fiscal buffer and the structure of spending worsened further.

The state-level budget for 2011 was only adopted by the country's tripartite Presidency in February 2012, while temporary financing arrangements – at the level of the 2010 budget execution – have been in place throughout the whole 2011, thus significantly hampering the functioning of state institutions and undermining the credibility of the fiscal policy.

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



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

([23]) This and other budget figures in this section are taken from the quoted release of the Macroeconomic Analysis Unit of the Indirect Tax Authority.

Medium-term budgetary strategy

Due to the prolonged political stalemate after the October 2010 general elections and the late state government formation in February 2012, the 2012 state-level budget had still not been adopted at the time of drafting this assessment. Provisional budgets – at the previous year execution level – are being implemented in the first two quarters of 2012, as was the case throughout 2011. Budget planning and fiscal coordination are strongly undermined by the continuing failure of local actors to agree on a medium-term fiscal strategy, in the absence of which the Federation and the Republika Srpska adopted their 2012 budgets (in January 2012 and December 2011, respectively) in violation of the country's legal framework([24]) for a second consecutive year. In a welcome development, the authorities agreed in mid-March on a medium-term expenditure ceiling for the state-level budget. According to the reached agreement, endorsed by the Fiscal Council, expenditures of the state institutions are to remain fixed over the medium-term at KM 950 million (representing 3.2% of the estimated countrywide GDP in 2011), while the allocation from the Single Account of the Indirect Tax Authority – making the bulk of state budget revenues – is to remain constant at KM 750 million. The 2012 entity budgets foresee increasing total spending (as compared to the revised 2011 entity budgets) by 4% in the Republika Srpska and 11% in the Federation, which somehow contradicts the overall fiscal consolidation([25]) projected in the EFP. This contradiction is evidenced within the EFP itself, as the macroeconomic scenario projects that the real growth of government consumption expenditures will exceed GDP growth in 2012, which combined with a projected rise of the public investment-to-GDP ratio will hardly allow for overall fiscal consolidation, as described in the fiscal scenario.

According to the EFP, consolidated budget revenues will decrease by 0.5 percentage points of GDP in 2012, due to unfavourable developments in property income and "other revenues". However, the programme fails to explain the underlying reasons for the significant drop in their collection. Social contributions are projected to grow in line with nominal GDP, thus assuming that the rising collection in the Republika Srpska will compensate for the lower receipts in the Federation. Tax revenues are seen to preserve their share in GDP at 19.9%. It is unclear, however, why the expansion of VAT proceeds falls behind nominal private consumption growth.

Consolidated expenditures are projected to decrease to 41% of GDP in 2012, representing a consolidation of 0.7 percentage points of GDP, which is based on strong adjustment in collective government consumption, an assumption which is not well founded in the programme. Notably, the projected reduction of the wage bill at all government levels by 0.6 percentage points of GDP might prove challenging to achieve against the background of the ongoing process of institutional building and the establishment of new state-level institutions. The fiscal scenario projects a slightly less ambitious – but probably more realistic – reduction of social transfers-to-GDP ratio of 0.3 percentage points, which should be mainly a result of the ongoing measures in the Federation. The capital expenditures are seen to increase faster than GDP in 2012 after a continuous decline since 2008.

([24]) According to the Law on Fiscal Council in Bosnia and Herzegovina, the entities should implement provisional budgets until a Global Framework on Fiscal Policies is finally agreed and adopted by the Fiscal Council.

([25]) It should be noted that a direct comparison between budget targets in the EFP and adopted budgets is not straightforward and might be misleading, due to the different methodologies used when compiling the budget documents, endorsed by the parliaments, and the budget table in the EFP annexes.

Table II.2.2:

Composition of the budgetary adjustment (% of GDP)

	2010([26])	2011	2012	2013	2014	Change: 2011-14
Revenues	37.3	40.4	39.9	38.7	37.4	-3.0
- Taxes and social security contributions	33.8	33.4	33.4	32.4	31.6	-1.8
- Other (residual)	3.5	7.0	6.5	6.3	5.8	-1.2
Expenditure	39.4	41.7	41.0	38.5	36.3	-5.4
- Primary expenditure	38.9	41.1	40.2	37.8	35.7	-5.4
of which:						
Gross fixed capital formation	3.1	2.9	3.3	3.2	2.6	-0.3
Consumption	16.3	17.8	16.9	15.8	15.1	-2.7
Transfers & subsidies	8.6	9.3	9.0	8.8	8.5	-0.8
Other (residual)	10.9	11.1	11.0	10.0	9.5	-1.6
- Interest payments	0.5	0.6	0.8	0.7	0.6	0.0
Budget balance	-2.1	-1.3	-1.1	0.2	1.1	2.4
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-1.6	-0.7	-0.3	0.9	1.7	2.4
Gross debt level	32.9	32.9	33.0	30.3	26.2	-6.7

Sources: Economic and Fiscal Programme (EFP) 2012, ECFIN calculations

The programme fails to explain the underlying budgetary measures to support the projected fiscal adjustment path in 2013 and 2014, which foresees a significant fiscal consolidation of 1 percentage point of GDP per annum. According to the EFP, the consolidated budget will turn into a marginal surplus in 2013 and post a surplus of 1.1% of GDP in 2014. In the Federation, budget surpluses to 0.9% and 1.3% of countrywide GDP are projected, while in the Republika Srpska the budget deficit will narrow to 0.6% in 2013 and 0.1% in 2014. The state-level budget deficit is projected to remain at 0.2% of countrywide GDP in each of the two years. Consolidated expenditures are projected to decline further to 38.7% of GDP in 2013 and 37.4% in 2014, which seems quite ambitious, especially having in mind the country's track record in implementing unpopular reforms. While the intended decline of current expenditures would be a welcome development, the drop of capital outlays – after a temporary rise in 2012 – is an issue of concern, given the extremely unfavourable current structure of public expenditures. The EFP claims that "the primary goal of the Government of the Federation of BiH in terms of management of public expenditures is … (to) open space for spending on investments and infrastructure", but surprisingly public investment in the entity is kept at the low 0.9% of the countrywide GDP throughout the whole programming period.

([26]) The consolidated revenue and expenditure figures for 2010 presented in the 2012 EFP are surprisingly low and significantly differ from official data, published by the Central bank of Bosnia and Herzegovina and the Macroeconomic Analysis Unit of the Indirect Tax Authority. This discrepancy points to the still low quality of budgetary reporting and suggests possible simultaneous use of different methodologies by the spending units and/or the consolidating institution. The assessment of the medium-term budgetary strategy is based on the projections as provided in the 2012 EFP.

While the projected path for the overall expenditures is overly ambitious, the foreseen evolution of revenues is surprisingly cautious. The fiscal scenario foresees a significant decline of the revenue-to-GDP ratio by 2.5 percentage points in the 2012-2014 period due to simultaneous negative developments in almost all revenue categories, which is left unexplained and does not seem consistent with the acceleration of real growth to 4-4.8% presented in the macroeconomic scenario.

The programme describes some possible fiscal risks, albeit only on the revenue side. Significant risks on the expenditure side, e.g. that the cuts foreseen in current spending may not be implemented to the planned extent or that some unforeseen spending rise might appear in the election years (2012, 2014), are not mentioned. The credibility of the presented medium-term fiscal framework would have benefited from a more thorough analysis of the downside risks and the elaboration of alternative fiscal scenarios.

Budgetary implications of "major structural reforms"

The 2012 EFP presents some links between the intended reform measures and the fiscal scenario, which is a slight improvement compared to the previous programme. However, only 4 out of 19 measures listed in the matrix of policy commitments (annex 3) – which has been provided for the first time – are accompanied by some estimates of their budgetary implications. The estimates are limited to the direct budget impact in 2012 only, showing a negligible drop of consolidated revenues by KM 10 million and a marginal rise of overall expenditures by KM 16 million. Overall, the programme still fails to provide a clear picture of the impact of structural reforms on the country's fiscal position.

Debt levels and developments

The 2012 EFP presents for the second consecutive year a coherent, comprehensive and well-structured overview and projection of both domestic and external public debt. In 2011, the public debt-to-GDP ratio is estimated to have remained unchanged year-on-year at 32.9%. External debt rose slightly to 22.8% of GDP while domestic debt declined to 10.1% of GDP. According to the EFP, the public debt will rise marginally faster than nominal GDP in 2012, before following a downward path in the next two years, reaching 26.2% of GDP in 2014.

Bosnia and Herzegovina’s external debt is projected to increase by 11% in nominal terms between 2011 and 2013, and then to drop by 6.3% to an estimated 19.7% of GDP in 2014. External debt is mostly denominated in EUR (44.7%), SDR (37.3%) and USD (9.2%). Given the country's currency board arrangement, the currency structure of external debt is relatively favourable. A large part of the debt is contracted on concessional terms with the average interest rate of all debt being at only 1.61%. Slightly over ½ of external debt has been negotiated with fixed interest rates, while the rest is with variable interest rates, its servicing being thus subject to risks in case of rising interest rates. The maturity structure is quite favourable with the average repayment period of the existing loan commitments estimated at 17 years. With regard to external debt servicing, the EFP notes the significant increase in 2013 (70.3% year-on-year) – caused by due repayments to the IMF –, but the authorities do not elaborate on their intentions for refinancing, which might be needed, given the tight fiscal space.

Domestic debt is serviced and managed by the entities. It is projected to decline throughout the whole programming period to 6.5% of GDP in 2014. Some 49.4% of this debt falls on the Republika Srpska and 48.9% on the Federation (the remaining part on the Brčko District). The bulk of domestic debt stems from old foreign currency savings and war claims. The entities service these liabilities by issuing bonds, while the Republika Srpska uses also privatisation and succession funds. In both entities, significant potential liabilities could arise in the context of solving the issue of property restitution.

Information on below-the-line operations and stock-flow adjustments is not provided.

Quality of public finances and institutional features

The 2012 EFP lacks a clear strategy to improve the quality of public finances. The specific section of the programme dealing with this issue describes some actions regarding fiscal statistics, which is a basic minimum in order to increase the transparency of fiscal policy and to facilitate the analysis and policy-making. Some additional information about the already implemented measures and near-term intentions in the field of quality of public finances may be found in other parts of the programme. The Federation intends to gradually reduce social contribution rates to address the issue of excessive labour taxation, which is a characteristic of the revenue composition in the country, albeit not explicitly spelt out in the EFP. Several mentioned measures are targeted at improving revenue efficiency, e.g. the already completed process of "fiscalisation" (introducing a compulsory requirement for fiscal cash registers in the retail and wholesale shops), the new Law on Tax Procedure in the Republika Srpska, and increased controls by the Indirect Tax Authority. Additionally, the Federation is aiming at opening space for spending on investments and infrastructure to address the extremely unfavourable structure of the expenditure system. However, the projected capital outlays in this entity remain constant at 0.9% of the countrywide GDP over the programming period. The underlying fiscal objective of the EFP is to reduce the large size of the public sector, which is another considerable weakness of the current public finances model.

The programme remains silent about other aspects of the quality of public finances like fiscal rules, prioritisation of spending areas/policies, medium-term budget planning, coordination between the different levels of government, etc. Budget planning and fiscal coordination, and thus the credibility of the fiscal policy as a whole, have been seriously undermined by the absence of a medium-term fiscal programme at the country level in the last couple of years. However, the authorities do not address this issue at all and do not propose measures to avoid such situation from occurring in the future.

2.6. STRUCTURAL REFORMS

Obstacles to growth and the structural reform agenda

The EFP does not present an analysis of the main structural obstacles to growth, as requested by the Commission. A stronger and sustainable economic performance in Bosnia and Herzegovina is mainly impeded by: i) a large government sector, characterised by low spending efficiency and sizeable interference in the economy, which distorts market signals; ii) an unfavourable business environment, which hampers private sector development; iii) a low quality of the human capital, combined with a dysfunctional labour market; iv) low production capacity and export base.

Key areas of structural reform

The structural reform part of the 2012 EFP still lacks an overall strategy, presented in a comprehensive and coherent manner. There is some improvement compared to the previous programme as the 2012 EFP describes measures and/or intentions in several key areas – such as pension system, financial sector, and social protection system –, which seemed to be missing from the reform agenda, as presented in the 2011 EFP. The programme focuses on the unfinished privatisation agenda and the needed reform efforts for improving the functioning of the labour market, while describing also some measures in the fields of public administration, health system and agriculture reforms. While broadening the scope of the reform agenda is a welcome development, there is significant room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation. Reform efforts also seem to be uneven across the country. The Republika Srpska seems to be more determined in addressing the structural reform challenges, while the Federation is lagging behind. In general, the described reform intentions would have been supportive – if operationalised by specific measures – of the fulfilment of the Copenhagen economic criteria and broadly follow the findings of the Progress Report.

Product and capital markets

With regard to product markets, the EFP focuses on enterprise privatisation and SME development, while it remains silent on other measures to improve the business environment and foster private sector development (e.g. strengthening of competition policy and state aid control, FDI attractiveness, and regulatory environment affecting the functioning of product markets). The privatisation process has stalled during the crisis period. It is well advanced in the Republika Srpska, as some 65% of the enterprises intended for privatisation have been already sold and about 25% are to be transferred to local governments or likely to be liquidated. Out of the remaining less than 100 enterprises, the entity government intends to offer for sale 50 companies in 2012. The Federation is lagging behind and has a largely unfinished privatisation agenda, as around 42% of the initial stock of state-owned capital intended for privatisation had been sold by the end of 2011([27]). The EFP expects that FDI worth KM 290 million will enter the economy in 2012 from the sale of Federation government-owned stakes in 8 companies, which have been included in the denationalisation list for several years already. Against a background of high uncertainty and unfavourable global economic environment, this might prove to be on the optimistic side The EFP describes the SME development strategy adopted by the Republika Srpska at end-2011. Its implementation is expected to increase the sector’s competitiveness over mid-term horizon.

Regarding financial markets, the EFP describes a number of already implemented changes in the regulatory framework and presents plans for such measures in 2012, mainly aiming at harmonisation of the regulatory framework with the EU *acquis communautaire*.

Labour market

The 2012 EFP lacks a comprehensive analysis of the major shortcomings in the functioning of the labour market, but – pointing at the persistently very high rate of registered unemployment – recognises the need for labour market reforms. The Republika Srpska refers to its first-ever medium-term employment strategy, adopted in 2011, which aims inter alia at stimulating economic growth, creating employment, increasing human capital’s quality and labour productivity, and reducing long-term unemployment, inactivity and social exclusion. The strategy is to be operationalised by annual action plans. The Federation lists a number of reform intentions in the fields of – among others – labour market flexibility and quality of labour supply. However, both entities fail to describe specific measures with explicit timeline for their implementation. The EFP mentions the Federation government's intention to dissociate the health insurance from employment services without elaborating further. Such motion could potentially result in a lower registered unemployment, as it is believed that significant part of the informally employed persons register at the employment offices to obtain health insurance from the state; another advantage expected by the authorities is that employment services can better do their own job.

Other reform areas

The 2012 EFP highlights several additional reform areas, which are considered to be important, such as public administration, pension and social protection systems, primary sector, and health system. The reform of public administration plays an important role in improving the efficiency of the public

([27]) According to latest data published by the Federation Agency for Privatisation.

sector and creating structures capable of adopting and implementing the EU acquis communautaire in Bosnia and Herzegovina. The programme lists several already implemented or ongoing projects, while information is scarce on future plans.

The EFP briefly describes the pension system reform in the Republika Srpska, effective as of January 2012, and only mentions that the Federation government aims at adopting a pension system reform strategy by the end of 2012 without providing any further details. The new Pension Law in the Republika Srpska introduces a credit system which is expected to stimulate longer working careers, establishes penalties for early retirement, and gradually increases retirement age. The law should improve the long-term sustainability of the public finances in the Republika Srpska, while the issue still needs to be urgently tackled in the Federation.

With regard to the intended reforms of health and social protection systems, the 2012 EFP outlines some broadly defined intentions and goals of the entity governments, but – like in other reform areas – fails to provide specific details. While reforms in these areas might have significant budgetary implications, the EFP presents only some estimates for the direct budget costs of two draft laws in the Republika Srpska.

2.7. OVERALL ASSESSMENT OF FORMAL REQUIREMENTS

Macro framework

The presented macroeconomic framework in the 2012 EFP appears optimistic both as regards 2012 and over the medium term. The recent macroeconomic developments are adequately described and include most of the relevant information available at the time of drafting. For the first time, the programme complies broadly with the requirement to present the main risks to the macroeconomic scenario. However, the programme does not comply with the Commission's request to provide an assessment of the medium-term sustainability of the country's external position.

Fiscal framework

The 2012 EFP fails to present a coherent and consistent overall fiscal strategy. The fiscal framework lacks a comprehensive description of medium-term measures – especially on the expenditure side –, which would support the targeted consolidation. The impact of some briefly mentioned measures could have been quantified to a larger extent. The fiscal framework does not seem to be consistent with the medium-term macroeconomic framework. No explicit links are made to the findings of the Progress Report. The compilation and presentation of fiscal data is not yet fully in line with GFS methodology, while there are no roadmaps for the introduction of ESA95. Some data inconsistences and discrepancies point to the still low quality of budgetary reporting and suggest possible simultaneous use of different methodologies by the spending units and/or the consolidating institution.

Structural reforms

The programme does not present an analysis of the main growth bottlenecks, as requested by the Commission, to allow for the development of a targeted structural reform strategy. There is significant room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation.

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