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2013 Pre-accession Economic Programmes of Iceland, the Former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey: EU Commission's overview and assessments

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European Commission
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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2013 Pre-accession Economic Programmes of the candidate countries (Iceland, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey).

One of the economic priorities of the 1999 and 2000 Accession Partnerships was the establishment of an annual fiscal surveillance for the candidate countries. This gave birth to the so-called Pre-Accession Fiscal Surveillance Procedure, which aims at preparing countries for the participation in the multilateral surveillance and economic policy co-ordination procedures currently in place in the EU as part of the Economic and Monetary Union. The Pre-Accession Economic Programmes (PEPs) are part of this procedure.

The preparation of PEPs serves two objectives. First, the programmes outline the medium-term policy framework, including public finance objectives and structural reform priorities needed for EU accession. Second, they offer an opportunity to develop the institutional and analytical capacity necessary to participate in EMU (with derogation from 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 five countries have published their 2013 programmes, which can be found on the web under the following addresses:

The former Yugoslav Republic of Macedonia:
http://www.finance.gov.mk/files/u1/sion_Economic_Programme_2013_2015_en_version.pdf

Iceland:
http://eng.fjarmalaraduneyti.is/media/frettir/Pre-Accession-Economic-Programme-2013_FINAL.pdf

Montenegro:
http://www.mif.gov.me/en/news/119232/Montenegro-Pre-accession-Economic-Programme-2012-2015.html

Serbia:
http://mfp.gov.rs/UserFiles/File/dokumenti/2013/PEP%20-%20en1.pdf

Turkey:
http://www.mod.gov.tr/en/publications/Pre-Accession%20Economic%20Programme%202013-2015.pdf

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The programmes and this assessment were discussed at experts' level in two multilateral meetings held in Brussels on 24 April and 30 April 2013 and at ministerial level during the ECOFIN Council on 9 July 2013. Representatives from EU Member States, the ECB, the Commission and the candidate countries attended this meeting.

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Part I

Horizontal Overview of the 2013 Programmes

1. HORIZONTAL OVERVIEW OF THE 2013 PROGRAMMES

2012 saw a marked slowdown of economic growth in all of the candidate countries and some entered into a new recession. Serbia's GDP contracted by 1.7% while output also fell in Montenegro (by 0.5%) and in the former Yugoslav Republic of Macedonia (by 0.2%)([1]). Following two years of strong expansion, Turkey's real output growth decelerated to 2.2%. Iceland's recovery from the deep crisis lost steam during 2012 with the growth rate falling to 1.6%.

A combination of external and domestic factors created obstacles to higher growth. Given the candidate countries' exposure to the EU and specifically to euro area economies, continued uncertainties in the euro-zone weighed on their economic performance. In addition, unfavourable weather conditions in the Western Balkans dampened growth by affecting energy production, agriculture and tourism. With the banking sector still under pressure, domestic demand was also held back by a continued decline in lending in Montenegro during 2012 and subdued credit growth in Serbia and the former Yugoslav Republic of Macedonia. Credit growth also decelerated in Turkey, following a rapid expansion in previous years, in line with the objectives of monetary policy.

Table I.1.1:

Pre-Accession Economic Programmes 2013
Key indicators

	2009	2010	2011	2012e	2013	2014	2015
Real GDP growth (% change)							
Iceland	-6,6	-4,0	2,6	2,7	2,5	2,9	2,7
The former Yugoslav Republic of Macedonia	-1,0	2,8	2,8	0,5	2,0	3,2	3,8
Montenegro	-5,7	2,5	3,2	0,5	2,5	3,0	3,5
Serbia	-3,5	1,0	1,6	-2,0	2,0	3,5	4,0
Turkey	-4,8	9,2	8,5	3,2	4,0	5,0	5,0
Unemployment rate (%, LFS)							
Iceland	7,2	7,5	7,1	6,0	5,3	4,9	4,4
The former Yugoslav Republic of Macedonia	32,2	32,0	31,4	31,3	31,0	30,2	29,3
Montenegro	19,1	19,7	19,7	22,7	21,2	20,6	19,6
Serbia	16,1	19,2	23,0	26,2	26,0	25,3	24,6
Turkey	14,1	12,0	9,8	9,0	8,9	8,8	8,7
Current account balance (% of GDP)							
Iceland	-11,6	-8,0	-6,2	-7,5	-3,4	-5,5	-4,5
The former Yugoslav Republic of Macedonia	-6,8	-2,0	-3,0	-2,8	-3,8	-5,9	-6,5
Montenegro	-27,9	-23,0	-19,6	-20,0	-21,0	-20,4	-19,7
Serbia	-7,2	-7,6	-8,9	-11,0	-9,0	-7,9	-7,0
Turkey	-2,2	-6,4	-10,0	-7,3	-7,1	-6,9	-6,5
Inflation (CPI, annual % change)							
Iceland	12,0	5,4	4,0	5,3	4,1	3,1	2,6
The former Yugoslav Republic of Macedonia	-0,8	1,6	2,3	-0,6	0,2	-0,5	-0,3
Montenegro	3,4	0,5	3,1	4,0	2,7	2,5	2,5
Serbia	6,6	10,3	11,0	7,5	11,1	4,8	4,5
Turkey	6,3	8,6	6,5	9,2	7,0	4,9	5,0

Sources: Pre-Accession Economic Programme (PEP) 2013 for 2011-2015, CCEQ for 2009 and 2010.

Economic growth is projected to recover over the programme period, driven mainly by domestic demand. The PEPs' growth estimates for 2013 range from 2% (Serbia and former Yugoslav Republic of Macedonia) to 4% (Turkey). In most candidate countries, growth is projected to accelerate in the outer two years and to reach – in 2015 - 3.5% in Montenegro, 3.8% in the former Yugoslav Republic of Macedonia, 4% in Serbia and 5% in Turkey. Iceland is the exception given its relatively moderate growth trajectory in the range of 2.5-2.9%. Across the countries, private consumption and investments are

([1]) Data quoted for 2012 refer to the most recent figures available which may thus differ from PEP data reported in the tables.

expected to contribute most to output growth, with the noteworthy exception of Serbia where the PEP projects a shift to a growth pattern based, besides stronger investments, on stronger net exports. Overall, and similarly to last year's submissions, the programmes' macroeconomic assumptions appear to be on optimistic side. Downside risks include possible renewed tensions in the external economic environment which could lead to lower than expected foreign demand, heightened inflationary pressures, delays in implementing structural reforms and improving the business environment, as well as uncertainties with respect to the strength of capital inflows and investments in general. A rising share of non-performing loans might keep banks from increasing lending, whereas a lower than expected growth in employment and disposable incomes as well as continued deleveraging pressures risk delaying a pick-up in domestic demand.

External imbalances are set to persist and constitute a source of vulnerability. Current account deficits might be a natural occurrence accompanying the catching up process of countries with relatively low levels of output per capita, reflecting a situation where investment needs outstrip savings. However, persistent external imbalances might also point to a lack of competitiveness which, along with the need to secure the financing of the deficit, requires careful consideration. The PEPs paint a mixed picture in this respect. In general, in the context of the foreseen domestically led recovery, reducing external imbalances is likely to prove challenging given the relatively high import content of consumption and investment. The financing of current account deficits should ideally be provided in the form of strong FDI inflows, helping to raise value added in manufacturing and improve the countries' export potential. This is the somewhat optimistic scenario set out in the PEPs for the former Yugoslav Republic of Macedonia and Montenegro. In Serbia, exports are set to contribute to an important adjustment of the trade deficit in the short term, but longer term prospects remain more uncertain. Turkey not only intends to secure more stable external financing by attracting stronger FDI inflows but also to raise national savings, so as to reduce its high reliance on short-term external financing. The current account situation in Iceland stands apart due to the legacy of the 2008 crisis: although the underlying current account is projected to remain virtually balanced over the medium term, balance of payment pressures could emerge from a huge stock of foreign liabilities, while tight capital controls limit the country's access to international capital markets and foreign investments. In general, the 2013 PEPs reveal that candidate countries still had difficulties to fully adhere to the requirement to provide a more forward looking assessment of external sustainability, notwithstanding the efforts made in particular by Serbia and the former Yugoslav Republic of Macedonia.

Fiscal discipline and budgetary planning leave ample room for improvement. Weaker than expected economic activity in 2012 led to a shortfall in revenues in several of the candidate countries, exacerbating the tendency for governments to resort to ad hoc adjustments in the course of the budget year. Such a short-term oriented fiscal policy often leads to cutting capital outlays in an effort to rebalance the budget, leaving aside considerations for a spending pattern more conducive to long-term growth. Overall, even following mid-year adjustments, the budget deficit in 2012 turned out to be higher than expected in Montenegro, the former Yugoslav Republic of Macedonia, and especially in Serbia, where the election year saw expenditures go off track. These imbalances led to a further build-up of public debt in these countries, continuing the trend of recent years.

Table I.1.1:

**Pre-Accession Economic Programmes 2013
Fiscal indicators**

	2009	2010	2011	2012e	2013	2014	2015
Total revenue* (% of GDP)							
Iceland	40,9	41,5	41,9	43,5	44,1	43,8	44,0
The former Yugoslav Republic of Macedonia	33,2	34,8	31,9	33,6	31,7	31,2	30,7
Montenegro	45,4	42,3	39,7	38,6	37,1	36,0	35,6
Serbia	42,3	41,0	41,0	43,6	44,1	44,1	43,7
Turkey	34,6	35,4	36,4	37,0	37,9	37,2	36,6
Total expenditure* (% of GDP)							
Iceland	50,8	51,5	47,3	45,1	44,4	42,8	42,0
The former Yugoslav Republic of Macedonia	36,0	37,3	34,4	36,3	35,4	34,5	33,7
Montenegro	51,1	47,2	45,2	41,7	39,4	37,7	36,3
Serbia	46,7	45,6	46,0	49,8	47,7	46,0	44,7
Turkey	40,1	38,3	36,8	38,6	39,4	38,4	37,5
General government balance (% of GDP)							
Iceland	-9,9	-10,1	-5,4	-1,6	-0,3	1,0	2,0
The former Yugoslav Republic of Macedonia	-2,7	-2,5	-2,5	-2,7	-3,7	-3,3	-3,0
Montenegro	-5,7	-4,9	-5,5	-3,1	-2,3	-1,7	-0,7
Serbia	-4,5	-4,7	-5,0	-6,1	-3,6	-1,9	-1,0
Turkey	-5,7	-3,6	-0,4	-1,6	-1,5	-1,2	-0,9
General government debt (% of GDP)							
Iceland	106,6	124,3	101,0	96,2	91,4	86,4	80,9
The former Yugoslav Republic of Macedonia	23,9	24,6	27,9	31,9	30,5	32,2	33,5
Montenegro	38,2	40,9	44,4	52,1	54,5	54,3	51,7
Serbia	34,7	44,5	50,3	65,1	65,2	58,7	58,4
Turkey	45,5	41,6	39,2	36,5	35,0	33,0	31,0

Sources: Pre-Accession Economic Programme (PEP) 2013 for 2011-2015
* 2010 data from PEP 2012, 2009 data from PEP 2011.

Fiscal consolidation strategies are subject to significant risks. All PEPs, except that of the former Yugoslav Republic of Macedonia, foresee gradual improvements of the budget balance in the period 2013-2015. Montenegro and Serbia set out an ambitious strategy to rein in the deficit and reverse the increase of public debt, mainly by lowering the expenditure-to-GDP ratio. After some relaxation in 2012, Turkey also envisages a back loaded and expenditure-led fiscal tightening over 2013-2015. Iceland expects an improvement of the budget balance of around 3.5 percentage points to turn to a budget surplus of 2% of GDP by 2015. Overall, a tighter fiscal stance seems appropriate for all candidate countries, but is surrounded – to a varying degree - by uncertainties, such as optimistic growth assumptions and a lack of concrete measures underpinning the consolidation plans. Fiscal policy's credibility would greatly benefit from the presence of transparent fiscal rules firmly anchoring expectations for sustainable public finances.

Structural weaknesses hampering growth potential call for more determined action. Structural problems in candidate countries of the Western Balkans include a low degree of economic diversification, high jobless rates, a large informal sector, skills mismatches, deficiencies in transport and energy infrastructures, often inefficient competition and weaknesses in the business environment. In Iceland, overall growth performance is held back by crisis-related as well as structural constraints, such as a fragile situation in the banking sector, a restrictive capital market regime hampering foreign investments as well as a limited diversification of the country's production and export structures. In Turkey, reforms should aim to shift employment to higher-quality jobs in formal activities and to raise female participation, alongside introducing greater competition in product markets. Even if challenges are correctly identified, the 2013 PEPs reveal a varying focus and degree of ambition. They would benefit from being based more strongly on an analysis of the structural bottlenecks to growth and from including clear targets and a commitment to the execution of major measures. The full and determined implementation of the proposed reforms should strengthen the economies of the candidate countries and support deeper integration with the EU.

Part II

Country analysis

1. ICELAND

Executive Summary

Following the 2008 crisis and the collapse of its financial system, Iceland has made remarkable efforts at stabilising its economy. Supported by an IMF programme and significant official external financing, the authorities concentrated their crisis management at reconstructing a domestically oriented banking sector, reducing fiscal deficits and stabilising the exchange rate. The policy response proved successful in spurring economic growth in 2011 and 2012, lowering unemployment and reducing inflation. However, the recovery lost some momentum during 2012 and real GDP growth fell to 1.6% from 2.9% a year before. The country's output level remains still some 5% below its pre-crisis peak, or at a similar level as in 2005.

The medium-term growth outlook could be less favourable than projected by the authorities. Amid global uncertainties, the financial position of households and firms remains difficult and deleveraging pressures are expected to continue. Moreover, the gradual fading out of temporary income boosting support schemes together with persistently high inflation has been eroding the growth of disposable income. Given the need for further fiscal adjustment, public consumption is unlikely to contribute to growth over the medium term. Investment growth has remained rather subdued, reflecting over-leveraged firms and prevailing uncertainty concerning the country's investment environment, in particular in the natural resource and energy sectors. Indeed, investment levels as a percentage of GDP remain worryingly low, and are rightly perceived by the authorities as a major concern.

At the outset of the crisis, a tight regime of capital controls was introduced to protect the economy from rapid and massive capital outflows and an even harsher drop of the krona. A swift removal of controls is complicated by a huge overhang of ISK assets held by non-residents and widespread price indexation of loans. However, still being in place, capital restrictions are limiting competition in the capital market, have a negative impact on the business climate and deter access to finance as well as domestic and foreign investment. Devising a convincing strategy that allows for a gradual capital liberalisation while safeguarding macro-financial stability through macro-prudential tools remains one of the core economic policy tasks.

Following the crisis, Iceland experienced a marked narrowing of its current account deficit and the programme's outlook is rather benign, expecting small "underlying" current account surpluses, i.e. net of accrued interest of banks in winding up proceeding,. However, significant balance of payments pressures could emerge from a large stock of foreign liabilities. While foreign exchange reserves are reported to currently cover maturing sovereign debt repayments until 2021, private sector deleveraging poses risks. This concerns primarily maturing debt of firms with no or little foreign exchange income and limited access to credit. Moreover, existing vulnerabilities result from a significant "legacy stock" of liquid offshore krona holdings as well as assets of the old banks in winding-up proceedings, representing together an estimated 50-60% of the country's GDP. In addition, a substantial outflow of resident krona holding could further aggravate the country's financial situation. These assets are currently locked in by capital controls, but could potentially lead to harsh balance of payments pressures once the liberalisation process starts.

Based on a largely expenditure-based fiscal adjustment, the general government deficit declined from 10% in 2010 to 3.4% in 2012. But a high level of the public debt of around 100% of GDP remains a source of vulnerability. The authorities' long-term objective to bring the public debt ratio down to 60% is welcome, but requires further public finance consolidation down the road. However, implementing expenditure restraint has become more challenging following years of fiscal adjustment. The recent recourse to a multitude of ad-hoc and partly temporary measures to enhance revenues may

improve the fiscal position in the short term, but does not spare the authorities from developing and enacting a set of structural fiscal policy measures that could effectively support fiscal policy objectives in the medium-to-long term. Along with this, the composition of the budget would need to be changed towards more growth-conducive spending and revenue patterns.

The 50% depreciation of the exchange rate during 2008 had pushed annual inflation to a peak of around 18% by end-2008. Subsequently, a tight policy mix allowed a process of dis-inflation, however, with an end-year rate of 4.2% in 2012, inflation still remains above the central bank's target of 2.5%. Persistently high inflation expectations point to underlying inflation pressures, driven by a weak currency and wage increases above productivity growth. As in other resource-based economies, wage increases in the profitable tradable (maritime and aluminium) sectors with high domestic currency earnings due to the depreciated exchange rate tend to spill-over to the non-tradable sector, resulting in higher unit labour costs and inflation. The authorities' intention to bring inflation back to the target range by 2014 seems to require a significant wage moderation going forward.

Stronger capital positions of banks and progress in private sector debt restructuring have lowered financial system risks over the past years, but financial intermediation remains impeded by a still unfinished restructuring of the banking sector and uncertainties about asset quality. The share of non-performing loans has been reduced significantly, but still remains at some 10% of total loans. Banks are faced with liquidity risks as they rely mostly on short-term deposits. Furthermore, due to the capital controls deposits are currently protected from being moved outside Iceland, providing a competitive advantage which is likely to disappear once restrictions start to be lifted.

Structural bottlenecks, such as the country's low degree of economic diversification makes the country vulnerable to asymmetric shocks and impedes the lifting of its growth potential over the short and medium term. Thus, raising potential growth will have to rely to a great extent on efficiency gains in existing sectors with low labour productivity, such as the domestic services sector. This would in turn allow for a re-allocation of labour to other, more productive and internationally oriented sectors and could strengthen the country's export base. In order to close existing productivity gaps in the tradable sectors, it seems essential to further open up the economy to foreign direct investment as well as to international competitive forces and best practice and to increase firms' economies of scale.

1.1. ECONOMIC OUTLOOK AND RISKS

The PEP expects a moderate, domestic demand driven recovery to continue. Average real GDP growth is projected to be at around 2¾% over the programme period, mainly based on robust private consumption and a recovery of domestic and foreign investments as well as gradual increases in exports. Private consumption is foreseen to remain the main source of growth, increasing by about 3% on average over the programme horizon, supported by higher employment and real wages rising by up to 2.5%. Investments are expected to gain momentum, albeit from a historically low level, and to grow by 11% on average, as big energy-intensive projects are expected to be completed in 2014 and 2015 after several years of delay. As this will require considerable purchase of inputs from abroad, the growth of imports is set to accelerate to 7%. The performance of exports is expected to benefit from a continued strong growth in services, namely tourism and transport. Furthermore, the completion of big investment projects is seen to result in stronger export growth as of 2015.

Table II.1.1:

Comparison of macroeconomic developments and forecasts

	2011		2012		2013		2014		2015	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	2,6	**2,6**	2,3	**2,7**	2,0	**2,5**	2,7	**2,9**	n.a.	**2,7**
Contributions:										
- Final domestic demand	2,8	**2,6**	1,8	**3,0**	1,6	**1,9**	2,6	**4,3**	n.a.	**1,8**
- Change in inventories	0,6	**0,4**	0,0	**-0,3**	0,0	**-0,1**	0,0	**-0,3**	n.a.	**0,1**
- External balance of goods and services	-0,8	**-0,4**	0,4	**0,0**	0,4	**0,6**	0,1	**-1,1**	n.a.	**0,8**
Employment (% change) [1]	0,0	**0,0**	0,9	**1,1**	0,8	**2,0**	1,0	**1,4**	n.a.	**1,6**
Unemployment rate (%)	7,1	**7,1**	6,1	**6,0**	5,7	**5,3**	5,2	**4,9**	n.a.	**4,4**
GDP deflator (% change)	3,2	**3,2**	5,0	**4,0**	3,6	**4,2**	2,5	**3,4**	n.a.	**3,0**
CPI inflation (%)	4,0	**4,0**	5,2	**5,3**	3,5	**4,1**	2,7	**3,1**	n.a.	**2,6**
Current account balance (% of GDP) [2]	-7,0	**-6,2**	-5,8	**-7,5**	-4,8	**-4,0**	-5,5	**-5,5**	n.a.	**-4,5**

Sources: Pre-Accession Economic Programme (PEP) 2013; Commission 2013 Winter Forecasts (COM)

1) Employment definitions differ and data are incomparable.

2) PEP CA 2013-2015 forecast updated after submission

While the programme's outlook appears largely plausible, risks are tilted to the downside. Amid global uncertainties, the financial position of households and firms remain difficult among others due to still high private sector debt, which rose sharply as a result of widely used inflation-indexation. The gradual fading out of temporary income boosting support schemes together with persistently high inflation has been eroding growth of disposable income and could imply a less dynamic private consumption profile. Furthermore, foreign debt deleveraging could exert an additional pressure on the exchange rate and on inflation. Investment growth has remained rather subdued and volatile in recent years, reflecting over-leveraged firms and prevailing uncertainty concerning the country's investment environment, in particular in the natural resource and energy sectors. A weaker recovery of Iceland's major overseas markets could also undermine export performance. Furthermore, some export sectors have benefited from a competitive real exchange rate and may start losing price competitiveness as the economy recovers. Overall, compared to the latest Commission forecast from February 2013, Iceland's economic framework appears to be slightly on the optimistic side.

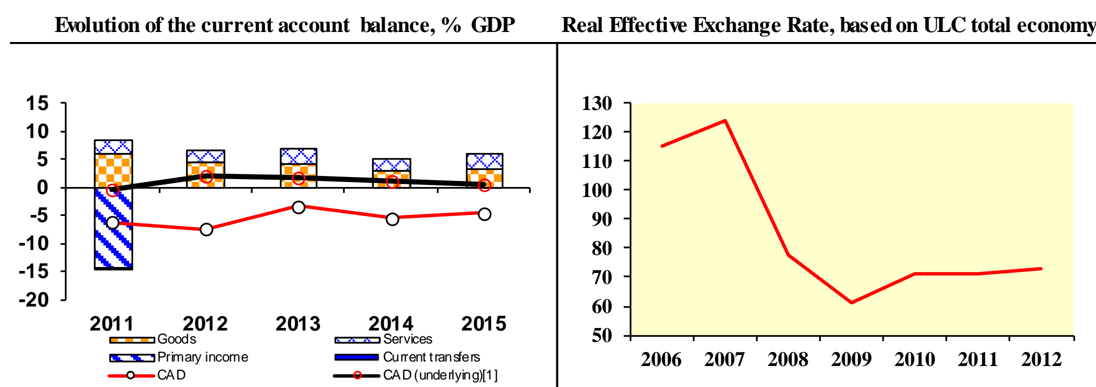
Labour market conditions will further improve. The growth of employment growth will average at 1½% annually and the rate of unemployment is set to continuously decline to 4.4% in 2015. Empirical evidence suggests that Iceland's labour market reacts in a flexible way to swings in the business cycle. Thus, it seems reasonable to assume a further increase in employment levels. However, given moderate output growth and relatively high real wage increases, the projected employment gains might be somewhat on the optimistic side.

The projected disinflation seems to underestimate underlying wage pressures. Lower oil and international commodity price and a strengthening of the exchange rate are expected to support a marked drop in inflationary pressures, from 5.2% in 2012 to 2.6% towards the end of 2015, only marginally above the Central Bank's inflation target of 2.5%. This inflation outlook appears optimistic and may well underestimate the impact of real wage pressures. Rather high wage settlements in 2011 and 2012 seem to have led to an entrenchment of high inflation expectations, which might impede a swift reduction in inflation during the programme period. Moreover, the inflation outlook strongly relies on the assumption of continued exchange rate stability of the *króna* against the *euro*, which is expected to act as a nominal anchor over the programme horizon. However, preserving *króna* stability

has proven to be a particular challenge, not least in view of pressures resulting from on-going foreign debt deleveraging and in the context of the gradual lifting of capital controls.

Graph II.1.1 : **External competitiveness and the current account**

Evolution of the current account balance, % GDP | **Real Effective Exchange Rate, based on ULC total economy**



[1] CBI estimate

Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN services

The rather benign outlook for the current account disguises potential balance of payments pressures. In line with robust private consumption and a pick-up in investment, the economic outlook envisages an end to the recent improvements in external trade. The balance of trade and services is seen to remain in surplus at around 6-7% of GDP over the programme period. The outlook for the current account remains complicated by the impact of banks in winding-up procedures. Accrued interests of these banks, which do not reflect any current or future outflow of funds, have a high weigh in the income balance. Net of these effects, the "underlying current account" reported a small deficit in 2012 and is projected to run a surplus of around 2% over the medium term, mainly benefitting from lower interest cost. While the current account scenario appears largely plausible under the current regime of capital controls, balance of payments pressures could emerge from a huge stock of foreign liabilities. Foreign exchange reserves currently cover maturing sovereign debt repayments until 2021. However, private sector deleveraging could rapidly deplete reserves. This concerns primarily maturing debt of firms with no or little foreign exchange income and limited access to credit. Moreover, existing vulnerabilities result from a huge "legacy" stock of liquid krona assets held by non-residents and by the estates of the failed banks, representing together an estimated half of the country's GDP. These assets are currently locked-in by capital controls, but could potentially lead to significant balance of payments pressures once the liberalisation process starts.

Persistent vulnerabilities in the banking sector will continue to constrain financial intermediation and the supply of credit. Stronger capital positions of banks and progress in private sector debt restructuring have lowered financial system risks over the past years. However, financial intermediation remains impeded by uncertainties about asset quality, a high degree of short-term funding and a still unfinished operational and financial restructuring of the banking sector. Banks carry relatively high cost-to-income and cost-to-asset ratios and asset quality is plagued by a rather high share of non-performing loans of some 20% on a cross-default basis and some 10% according to a more commonly used definition. On the funding side, banks rely mostly on short-term deposits and need to increase the share of term deposits to reduce liquidity risks. Currently, due to the capital controls, deposits cannot be moved outside Iceland, providing a competitive advantage which is likely to disappear once restrictions start to be lifted.

1.2. PUBLIC FINANCE

The fiscal deficit in 2012 was further reduced to 3.4% of GDP, but remained twice as large compared to the target. The authorities had initially envisaged a largely balanced budget for 2012, which during the course of the year was softened in two steps to a deficit target of 1.7% of GDP. These adjustments were mainly introduced to accommodate weaker than expected economic growth, more favourable refinancing conditions and the decision to increase spending, in particular on public sector wages, to accommodate rising wage demands, largely driven by persistently higher than expected inflation. Despite this fiscal loosening, the 2012 budget managed to reduce the deficit by 2 percentage points of GDP. About two thirds of this fiscal adjustment in 2012 was the result of stronger revenues, while savings on the spending side, mostly in the area of social security and defence, contributed another third. On the revenue side indirect taxes benefited from an increase in the VAT rate (to 25.5%), but higher income from corporate taxes also boosted public revenues.

The fiscal strategy for 2013-2015 targets a marked reduction in the debt ratio through substantial fiscal surpluses. Faced with a debt burden of nearly 100% of GDP and a high uncertainty on still surfacing costs of the 2008 financial sector crisis, the government defined the rapid reduction of public debt as one of its core fiscal objectives. Substantial primary surpluses are seen as a key instrument in this respect, which should be achieved through reducing public spending in a socially acceptable way while increasing revenues. Over the programme period, the debt ratio is expected to drop by some 15 percentage points, from estimated 96.2% of GDP in 2012 to 80.9% in 2015 in rather equal steps each year. In a slightly front-loaded and expenditure-led adjustment approach, the general government budget balance is set to turn from a projected deficit of 1.7% of GDP in 2012 to a surplus of 2%% in 2015. The spending ratio is planned to fall markedly, from 45.1 % of GDP in 2012 to 42% in 2015. Revenues are programmed to increase slightly by 0.5 percentage points to 44% of GDP. Given the rather high share of interest costs of some 5% of GDP, this deficit profile implies substantial primary surpluses, increasing from 3.3% in 2013 to 5.2% in 2015.

Box II.1.1: The budget for 2013

The parliament adopted the 2013 budget on 20 December, which targets a central government deficit of 0.2% of GDP in 2013. This represents a fiscal adjustment of 1.5 percentage points of GDP. The features of the 2013 budget are in line with the medium-term budget, adopted in 2012. The primary balance is supposed to register a surplus of 3.2% of GDP. Revenues and spending are expected to account for 30% and 30.2% of GDP, respectively. These targets are based on a projected 2.7% real growth in GDP and an average inflation rate of 3.9%.

Main measures in the budget for 2013

Revenue measures*	**Expenditure measures****
VAT (+0.3% of GDP)	"Restraint measures" (-0.4% of GDP)
Social contributions (+0.2% of GDP)	Childcare etc. (+0.5% of GDP)
Excise taxes (+0.2% of GDP)	Interest payments (+0.5% of GDP)
Payroll tax (+0.2% of GDP	

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Sources: .PEP 2013

The 2013 budget aims to strike a balance between fiscal adjustment and supporting economic recovery. The budget foresees higher allocations for increasing child benefits and transfers to the childbirth leave fund, which are compensated for by additional restraint measures, mainly in the area of material spending of line ministries (see Box). On the revenue side, emphasis is given to resource and income related taxes. Additional tax measures, such as the extension of carbon and energy taxes into 2013, an increase in the pay-roll tax by 0.3 percentage points, and the extended application of the standard VAT rate to hotels, are expected to increase revenues by about 1% of GDP. Risks to the budget may result again from a weaker-than-expected revenue performance. Implicit tax elasticities are rather benign, and projections for asset sales appear somewhat optimistic, given past years' performance. Moreover, additional spending pressures are likely to increase in the run-up to the general elections, some of which have already materialised in the form of wage increases at local level. Additional risks could emerge from claims to remove or reduce the fishing fee or to provide additional support for debt-ridden households. Therefore, the budget balance could turn out to be less favourable. Based on slightly lower tax elasticities and a somewhat higher projected current spending, the Commission's Winter forecasts projects a budget deficit of 0.5% of GDP.

The projected lowering of spending ratio in 2014 and 2015 will require the design and implementation of additional cost saving measures. For 2014 and 2015, the medium-term fiscal framework envisages an overall budgetary surplus of 1.1% and 2.0%, respectively. This improvement will mainly be the result of lower spending, dropping by 1.6 and 0.8 percentage points of GDP in 2014 and 2015, while revenues are expected to drop by 0.3 percentage points in 2014 and rise again by 0.2 percentage points in 2015. In 2014, about half of expenditure reductions, i.e., 0.7% of GDP are expected to be derived from lower public consumption, in the form of wage constraints and depressed current spending, in line with "restraint measures" applied in the years before. Unfortunately, the programme does not provide details about the nature and composition of the remaining spending cuts. Thus, it is difficult to assess whether the fiscal objectives are sufficiently backed by envisaged policies. The need to design and implement additional fiscal measures may thus re-emerge quickly, most notably in the context of preparing the 2014 budget. The Commission's latest forecast from February 2013 is more cautious concerning economic growth, revenue elasticities and spending targets and projects a smaller surplus in 2014 (+0.5% of GDP) which results in a slightly more slowly debt reduction.

Box II.1.2: Debt dynamics

In the course of the crisis, Iceland's public debt rose dramatically, from 29% of GDP in 2007 to 101% of GDP in 2011. The sharp increase was primarily due to the one-off costs of the financial crisis. By 2011, the debt ratio appears to have reached its peak. Since then the debt ratio has declined, mainly as a result of primary surpluses. However, due to the high debt burden, the resulting high interest payments of some 5% of GDP are still a substantial fiscal drain. Nominal GDP growth should help to reduce the debt ratio, but – in view of expected decelerating inflation – at a diminishing scale, i.e. from a debt reducing effect of 6.4 percentage points in 2012 to 4.7 percentage points in 2015. The maturity profile envisages significant repayment obligations in 2016 and 2022, which are however not covered in the programme.

Table II.1.3:

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

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**101,0**	**96,2**	**91,4**	**86,4**	**80,9**
Change in the ratio	8,1	-4,8	-4,8	-5,0	-5,5
Contributions [2]:					
1. Primary balance [3]	**0,3**	**-3,3**	**-4,7**	**-5,8**	**-6,9**
2. "Snow-ball" effect	**0,0**	**-1,4**	**-1,0**	**-0,6**	**0,2**
Of which:					
Interest expenditure, net	5,1	4,9	5,0	4,8	4,9
Growth effect	-2,3	-2,6	-2,3	-2,5	-2,2
Inflation effect	-2,8	-3,8	-3,8	-2,9	-2,5
3. Stock-flow adjustment	**7,8**	**-0,1**	**0,9**	**1,4**	**1,2**

Notes:

[1] End of period.

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

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

Source: Pre-Accession Economic Programme (PEP) 2013; ECFIN calculations

The recent rapid accumulation of public debt has substantially reduced the room for manoeuvre of Iceland's authorities and has markedly increased the country's fiscal vulnerability.

Going forward, the composition of the budget would need to be changed towards a more growth-conducive spending and revenue pattern. Due to crisis-driven spending constraints, the authorities have embarked on reducing non-core spending and on reconsidering the appropriateness of spending patterns. Medium-term growth-enhancing expenditures, like public investment, have

Table II.1.4:

Composition of the budgetary adjustment (% of GDP)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenues	41,9	43,5	44,1	43,8	44,0	0,5
- Total taxes	31,8	-	-	-	-	-
- Other (residual)	10,1	-	-	-	-	-
Expenditure	47,3	45,1	44,4	42,8	42,0	-3,1
Primary expenditure (1)	42,2	40,2	39,4	38,0	37,1	-3,1
of which:						
Gross fixed capital formation	1,8	1,8	1,8	1,8	1,9	0,1
Consumption	25,3	24,9	24,3	23,6	23,0	-1,9
Transfers & subsidies	10,2	-	-	-	-	-
Other (residual)	4,9	-	-	-	-	-
Interest payments	5,1	4,9	5,0	4,8	4,9	0,0
Budget balance	-5,4	-1,6	-0,3	1,0	2,0	3,6
- Cyclically adjusted	-5,4	-1,7	-0,3	1,1	2,0	3,7
Primary balance (2)	-0,3	3,3	4,7	5,8	6,9	3,6
Gross debt level	101,0	96,2	91,4	86,4	80,9	-15,3

Sources: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations

(1) Expenditure minus interest payments; (2) as defined by the PEP: total balance corrected for net interest

unfortunately been among the victims of spending reduction and they are foreseen to remain at historically low levels over the programme horizon. The current expenditure structure may support short-term recovery and consumer confidence, but may not be conducive to sustainable long-term growth. Moreover, on the revenue side the authorities have been increasingly resorting to one-off and temporary measures, which have been frequently extended on an ad-hoc basis. The authorities seem to be aware that this short-term orientation risks eroding the efficiency of the tax system and eventually the sustainability of the country's fiscal adjustment. In this respect, a special working group on taxes, including the Chamber of Commerce and the Employers' Association, has been created to come up with tax policy proposals. Contingent liabilities are mainly linked to loss-making Housing Financing Fund which provides financing to households at favourable conditions. The Fund benefits from government guarantees and is still under-capitalised despite subsequent capital injections from the budget. The intention to launch a comprehensive review of the Fund's operations has been announced in the programme and should get utmost attention by the authorities. Finally, the financial risks deriving from a currently heavily under-funded public pension scheme would require an adequate policy response going forward.

A number of legal and administrative measures should further improve the quality of fiscal management. Fiscal planning and budgetary implementation is done on a rather advanced level. However, in recent years, fiscal targets usually were not fully met, partly due to over-optimistic revenue estimates, but also as a result of political decisions to adjust original plans in order to accommodate public calls for higher spending to alleviate the difficult financial situation of households and firms in the aftermath of the crisis. A new organic budget law likely to be adopted in the course of 2013 should strengthen the budget preparation and execution process, improve transparency and reporting and increase accountability, especially vis-à-vis the legislature.

1.3. SRUCTURAL REFORMS

The economy's overall growth performance is impeded by crisis-related and structural constraints. The programme contains a fair account of current growth bottlenecks and constraints. A fragile situation in the banking sector and tight financial conditions, a still elevated level of household and corporate sector indebtedness, and a low attractiveness for foreign investors due to the restrictive capital market regime are rightly seen as major obstacles to a faster recovery. Beyond crisis-related challenges, the limited diversification of the country's production and export structure impedes the country from taking advantage of new market developments. Some new industries have developed, such as pharmaceuticals and data storage providers for international firms. However, given the small size of the economy, possibilities for diversification remain limited. Thus, lifting the country's growth potential will have to rely to a great extent on efficiency gains, in particular in the low productivity domestic services sector. This would in turn allow for long-term re-allocation of labour to more productive sectors.

Given Iceland's small market size, competition policy is of crucial importance. During recent years, competition policy has been strengthened, notably to deal with dominant positions of certain companies in different markets. In order to close existing productivity gaps, it seems essential to further open up the economy to international competitive forces and best practice and to increase firms' economies of scale. This will require competition authorities to strike an important balance between corporate scale and consumer protection. The programme remains rather silent about intended policies in the field of competition.

There is scope for raising investments and productivity in the energy sectors. The programme focuses on rather long-term issues, such as the exploration of hydrocarbon production, which would require a long-term commitment of international investors as well as a careful evaluation of geological capacity constraints and environmental concerns. Although preparations have started and first licences

were issued, the programme does not expect production to start within the next 12 years. The possibility to connect Iceland to the European electricity grid is discussed as an attractive option to raise output of domestic energy companies and to gain access to internationally higher energy prices. The sheer scale of required investments as well as a possible domestic resistance motivated by fears of higher domestic energy prices puts a lot of uncertainty to this project.

The restructuring of Iceland's financial sector remains a key priority. A lively domestic debate about the future shape of Iceland's financial market has continued, and a group of experts has come up with recommendations to tackle a wide range of apparent weaknesses and structural problems, such as insufficient competition, a huge complexity and distorted incentives due to corporate governance weaknesses which in turn are partly due to uncertainties with respect to the future ownership structure in the banking sector. The authorities intend to introduce legislation shortly, on the separation of investment and commercial banking as well as on the establishment of a Financial Stability Council, which addresses some of the identified weaknesses. The programme does not contain any plans about government's divestment in the financial sector.

Structural adjustment is impeded by a restrictive capital movement regime. In the wake of the eruption of the financial crisis the authorities introduced capital controls to protect the economy from rapid and massive capital outflows and an even harsher drop of the krona. These emergency measures are difficult to remove as long as the issue of the outstanding ISK-debt overhang has not been resolved. However, still being in place, those constraints are limiting competition in the capital market, have a negative impact on the business climate and deter both domestic and foreign investment. Under these constraints, the authorities' endeavours to promote foreign investment are unlikely to be effective. The authorities appear to be aware of the high economic costs of the current capital control regime and the sensitivity and importance of addressing this issue. Work has started to develop options for lifting capital restrictions which could have been reflected more prominently in the country's programme. Translating the preparatory work into concrete measures will remain an important challenge going forward.

High long-term and youth unemployment remains a problem. Despite a rather well-educated and flexible labour force, as a matter of concern, long-term unemployment has reached about a quarter of total unemployment. With respect to unemployment, the government – as in the past – intends to strongly rely on active labour market programmes, in particular on-the-job-training and special education campaigns for long-term unemployed. Social security reforms aim to simplify and streamline eligibility criteria, review invalidity benefits and increase incentives to work for beneficiary recipients, which are hoped to stimulate participation in the labour market.

Annex: Overall Assessment of Programme requirements

The 2013 PEP covering the period 2012-2015 was submitted on 31 January 2013, after it had been discussed in parliament. Social partners have been involved while drafting the document. The programme is in line with government's medium-term financial strategy. References to the accession process and to related documents are rather limited.

Macro framework

The 2013 programme is largely an update of last year's programme, taking into account a number of comments from the previous assessment. The PEP presents a clear and concise picture of past developments and a medium-term macro-economic framework that is coherent and sufficiently comprehensive. It contains most of the elements, requested for the multilateral surveillance exercise but would have benefited from a deeper analysis, such as a sensitivity analysis of the country's balance-of-payment with respect to different scenarios of addressing the ISK debt overhang.

While high uncertainties and downside risks weighing on the economic outlook are acknowledged, no alternative, lower-growth, medium-term scenario is presented. Similarly, while upside risks from inflationary pressures are recognised, alternative scenarios on how to deal with possibly changed inflationary expectations are not provided.

Compared to the previous programme, the PEP is more explicit on the issue of non-price competitiveness, but it lacks an in-depth discussion about the sustainability and financing of the current account.

Future submissions would benefit from analysing the links between the financial sector and the medium-term growth scenario, which are of crucial importance for the sustainability of the economic recovery.

Fiscal framework

The fiscal framework is largely in line with the underlying macroeconomic framework, although the programme does not provide much information on the links between the macroeconomic and fiscal performance. Furthermore, the analysis and comparability suffers from a limited alignment with ESA 95 concepts of public sector accounts. There is no indication on the government's plans on aligning their accounting approach to the European System of Accounting (ESA). The PEP also continues to have a strong emphasis on central government instead of general government operations. Future submissions would benefit from more complete data (e.g. on composition of general government revenue and expenditure, long term fiscal projections, cyclical budget balance).

The programme does not provide a sensitivity analysis of the impact of changes to main economic assumptions (e.g. GDP growth, revenue growth, interest rates, exchange rates) on the fiscal position. It nevertheless outlines potential risks stemming from very high contingent liabilities. Future PEP submissions would benefit from a proper sensitivity analysis of the fiscal balance to changes in some key economic variables.

The document would also benefit from presenting the currency and maturity structure of public debt, in addition to a sensitivity analysis linking debt scenarios (stock and servicing) to deviations of key economic variables from base assumptions, such as GDP growth, inflation, exchange rates, interest rates (especially with a view to capital liberalisation).

Structural reforms

The structural reform framework is coherent but the level of detail in presenting some of the measures is insufficient.

The presented policy measures are linked to the reform priorities. Significant attention is devoted to cyclical, crisis-related challenges, such as fiscal and external imbalances and financial market stabilisation. Furthermore, the programme also tries to address more medium-term structural issues, such as job creation, addressing long-term unemployment and fostering regional development. The programme would also benefit from providing a clear timeline and sequencing of the planned measures, along with information about their estimated budgetary impact. The programme describes various measures undertaken in order to move towards capital market liberalisation, however, the programme is still very vague when it comes to present concrete milestones and a time frame for their implementation.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

Executive Summary

The economic situation deteriorated markedly during 2012 as output growth fell from 2.8% in 2011 to -0.2% in 2012 on the back of lower private consumption and declining exports. Against this background, the projected acceleration of GDP growth to 3.8% in 2015, based on a pronounced pick-up of private consumption as well as strong FDI inflows and public investments, may appear somewhat optimistic. Declining real wages together with moderate employment growth are likely to constrain the growth of private consumption while uncertainty may lead to a more subdued investment growth than foreseen by the authorities.

Structural weaknesses need to be addressed in order to raise the country's growth potential further. The labour market, the education system and the business environment are priority areas for the authorities. Persistently high unemployment rates of above 30% together with tenacious youth and long-term unemployment reveal shortcomings in the education system, a high degree of informality and the economy's limited capacity to create jobs which need to be addressed urgently. In 2012, employment generation appears to have taken place mainly in the public sector, such as in health, education, and at the municipal level, while manufacturing and agriculture shed labour. Stricter controls through the employment agency and active labour market programmes such as training, probably helped to bring down the number of registered unemployed. Yet, the ALMPs endowment is often modest and their effectiveness difficult to assess. A holistic approach including substantial structural reforms is needed.

Weaker than projected revenue growth but also significant arrears clearance - both VAT refund arrears and payment arrears for goods and services - led to a marked increase in the central government deficit to 3.8% of GDP, compared to a planned 2.5% of GDP. While, in the past, the government used to respect the initial deficit target by adjusting discretionary spending to the revenue performance during the course of the year, in 2012, the adjustment was very limited. The government's approach of persistent deficit spending has led to a strong rise in the public debt ratio, by some 10 percentage points of GDP since 2008, although the overall level probably does not exceed 40% of GDP. The fiscal strategy foresees the general government deficit to decline slightly until 2015, but to remain at about 3% on a cyclically adjusted basis. The central government's debt ratio is forecast to increase only moderately, to 33.5% of GDP in 2015, compared to 31.9% in 2012. The fiscal framework, based on rather optimistic revenue assumptions, would benefit from a more comprehensive medium-term fiscal strategy. The government's fiscal stance is expansionary and there are no indications when and how the authorities intend to return to a sustainable fiscal path.

The outlook for increasing external imbalances calls for vigilance. The current account deficit widened from 2.7% of GDP in 2011 to 3.9% in 2012 and is foreseen to further deteriorate to 6.5% in 2015. Its financing is expected to rely increasingly on a solid pickup in FDI inflows, which had receded markedly in 2012, and, as recent past experience suggests, is prone to some uncertainty. Furthermore, external debt is rising as the government relies increasingly on external sources to finance its budget deficits. The externally financed share of budget deficits is projected to grow further over the programme's horizon, while, at the same time, important repayments on external borrowing are due. These constraints necessitate a further substantial deepening and broadening of domestic debt markets, in particular into longer debt maturities.

2.1. ECONOMIC OUTLOOK AND RISKS

The macroeconomic framework is on the optimistic side, expecting a significant acceleration of GDP growth from 0.5% in 2012 to 3.8% in 2015. The scenario relies on a marked pick-up of private consumption, which is supposed to contribute two thirds of GDP growth, complemented by investment growth, which derives mainly from FDI and public investment. Furthermore, a gradually recovering global demand and the completion of export-oriented FDI projects should result in an important increase of exports, in particular in 2014 and 2015. However, due to the substantial import content of investment and exports, import growth is expected to remain high, resulting in an overall negative contribution of net exports to growth. On the supply side, GDP growth appears to be driven by industrial production and construction. The authorities arrive at an estimated potential growth rate of 3.4%, to be reached in 2014/2015. Although this estimate lies significantly above the 10-year average GDP growth of 2.6%, it may not be unrealistic given that there were two periods of crisis-related output declines in the last 10 years. However, the closing of the output gap might happen later than anticipated by the government.

Table II.2.1:

Comparison of macroeconomic developments and forecasts

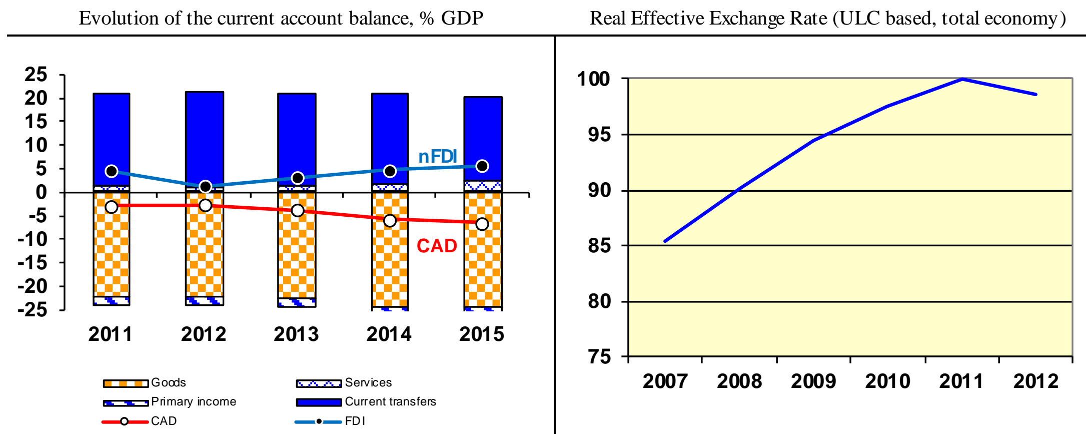
	2011		2012		2013		2014		2015	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	2,8	**2,8**	0,0	**0,5**	1,5	**2,0**	2,5	**3,2**	n.a.	**3,8**
Contributions:										
- Final domestic demand	5,3	**6,1**	1,9	**1,3**	2,3	**2,9**	3,4	**4,5**	n.a.	**5,3**
- Change in inventories	0,9	**n.a**	0,1	**n.a**	0,0	**n.a**	0,0	**n.a**	n.a.	**n.a**
- External balance of goods and services	-3,4	**-3,3**	-2,0	**-0,8**	-0,7	**-0,9**	-1,0	**-1,3**	n.a.	**-1,5**
Employment (% change)	1,1	**1,1**	0,5	**0,5**	1,0	**0,8**	1,5	**2,0**	n.a.	**2,5**
Unemployment rate (%)	31,4	**31,4**	31,2	**31,3**	30,7	**31,0**	30,0	**30,2**	n.a.	**29,3**
GDP deflator (% change)	3,8	**3,5**	2,3	**2,5**	2,8	**3,2**	2,3	**3,0**	n.a.	**2,7**
CPI inflation (%)	3,9	**2,3**	3,3	**3,3**	3,0	**3,5**	2,5	**3,0**	n.a.	**2,7**
Current account balance (% of GDP)	-2,7	**-3,0**	-3,4	**-2,8**	-3,8	**-3,8**	-4,7	**-5,9**	n.a.	**-6,5**

Sources: Pre-Accession Economic Programme (PEP) 2013, Commission 2013 Winter Forecast (COM)

The labour market outlook relies primarily on employment growth. The expected acceleration in employment growth from 0.5% in 2012 to 0.8% in 2013 and to 2% and 2.5% in 2014 and 2015, appears optimistic in view of the programme's growth profile and probably also includes increases due to public sector recruitment and stricter registration of so far unrecorded employment. The expected decline in the number of unemployed is rather limited, indicating difficulties in addressing the underlying factors for the high unemployment.

Stronger growth is likely to lead to significantly higher external imbalances. The government expects the current account deficit to widen significantly over the programme horizon, from -3.8% in 2013 to -6.5% in 2015. The main factor is a deterioration in the trade balance, reflecting strong domestic demand, in particular import-intensive investment. Incoming FDI would help to raise the value added in manufacturing, improve the country's export structure and thus gain market shares. Current transfers are supposed to decline slightly from their currently high level of 22% of GDP. Furthermore, an increasing outflow of dividends to foreign shareholders, earned on the established foreign direct investment in the former Yugoslav Republic of Macedonia, would also affect the country's external balance. Over the programme horizon, the financing of the current account deficit would rely for the most part on a marked increase in foreign direct investment.

Graph II.2.1 : **External competitiveness and Current account**



Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN services

Inflationary pressures are likely to persist in the medium term. While continued weakness in underlying economic activity in 2013 is likely to keep inflation at or below 3%, planned increases in electricity prices and strengthening domestic demand, given the gradual closing of the output gap, suggest that moderate inflation pressures may persist in 2014 and 2015, despite an expected decline in import price inflation. The government assumes that despite an overall declining trend, inflation rates remain elevated at the beginning of the year and annual average inflation in 2013 would be slightly higher than in 2012, at 3.5%,. For the remaining programme period, inflationary pressures are seen to decline and to reach 2.7% by 2015. The medium-term inflation scenario presented in the PEP appear broadly realistic, also considering that the potential growth rate could be reached only post 2015 and domestic demand pressures remain more subdued until then.

Key elements of the macroeconomic framework are subject to a substantial degree of uncertainty. The programme does not provide information on the development of real disposable income. In view of recent and on-going declines in real wages and moderate employment growth, the expected significant increase in private consumption looks quite optimistic. The programme's investment profile appears to rely on foreign investment, which in the past used to be rather uncertain in spite of government's strong commitment to attracting foreign investors, and on public funds for infrastructure investment, which, even though budgeted, in the past could not always be realised. Hence, the uncertainty about future investment also would have suggested a more subdued growth scenario than presented by the authorities. In view of the above, projected employment growth for 2014 and 2015 appears optimistic and would have deserved more explanation.

The programme's risk assessment focuses on external risks only. The programme discusses a number of risks, such as lower than expected growth in the euro area and the global economy; higher than expected inflation in 2013 due to commodity price changes and to the transmission of higher energy prices to other domestic prices; and a risk of lower than expected FDI inflows. The PEP mentions also some upside risks, such as stronger than expected private transfers, and growing export capacities in the economy (leading to bigger export market shares and further structural and geographic diversification of exports). Besides those risks, the macroeconomic scenario is subject to substantial uncertainties on the domestic side, such as lower job creation, leading to lower private consumption and thus lower growth, or stronger inflationary pressures due to domestic factors, such as higher food or energy prices.

Table II.2.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	1.569	1.666	1.861	2.673	2.742
Foreign ownership of banking system	61,4	61,0	61,3	59,4	58.7 Q2
Credit growth	40,3	14,2	5,4	8,1	7,3
Bank loans to the private sector ratio	0,97	1,00	1,00	1,00	0.98 Q3
Deposit growth	23,5	4,6	13,0	10,9	7,2
Loan to deposit ratio	0,91	0,99	0,93	0,90	0,90
Financial soundness indicators					
- non-performing loans	6,7	8,9	9,0	9,5	10.6 Q3
- net capital to risk weighted assets					
- liquid to total assets				31,2	30.2 Q2
- return on equity					
- forex loans to total loans %	22,3	21,9	25,3	27,7	25.3 Q3

Sources: National Central Bank, Ecowin/Reuters

The financial sector seems to be increasingly affected by the international and domestic economic deceleration, as the ratio of NPLs remains elevated, and deposit and loan growth is slowing down. Banks in the former Yugoslav Republic of Macedonia remain well capitalised, with a capital adequacy ratio on average of about 17%. The banking sector improved its profitability in 2012, mainly due to growth in net interest income. Loans are funded largely by domestic deposits, with a comfortable loan-to-deposit ratio of about 90%. However, deposit growth has been slowing, and is mainly derived from household savings, hence likely to be affected by the expected further deterioration of disposable income. Credit growth is expected to accelerate only moderately. The NPL ratio is expected to deteriorate further. Yet, at this point the risks to bank liquidity or solvency appear limited, as potential impairment is still fully provisioned for. However, in particular small, less well-capitalised local banks could face funding pressures.

2.2. PUBLIC FINANCE

Fiscal discipline and planning deteriorated in 2012, leading to a marked increase in the central government deficit from some 2.5% in 2011 to about 3.8% in 2012. In line with weaker than expected economic growth, revenues remained significantly below expectations. On an annual base, revenues rose by 0.7% only, while the authorities had anticipated an increase by 9%. As a share of GDP, total realised revenues remained almost constant at about 30% in 2012 compared to 2011. When confronted with increasing financing gaps, the authorities resorted to delaying accrued payment obligations, such as due bills for contracted work and VAT reimbursements. Only in the second half of 2012, the authorities officially acknowledged the full extent of those revenue shortfalls and agreed to execute the due payments until early 2013. Those delayed payments were expected to increase the deficit from the originally planned 2.5% of GDP to 3.5%. However, according to preliminary data, the central government deficit was 3.8% of GDP. This higher-than-expected deficit was largely financed by an international loan, amounting to 3¼% of GDP. On the spending side, the authorities remained closer to their overall spending targets, raising spending by 4.8%, compared to a planned increase of 8.8%. In terms of GDP, expenditure rose from 30.2% of GDP in 2011 to 33.8% in 2012. The published deficit is based on cash accounting, while using an accrual approach the 2012 deficit would probably have been higher. Furthermore, the issue of unrecorded payment obligations is distorting the published deficit profile and compliance with European accounting standards has remained weak.

Contingent liabilities, in the form of sovereign guarantees, remained at about 4% of GDP by September 2012, and do not seem to pose risks to public finances.

Table II.2.3:

Composition of the budgetary adjustment (% of GDP, general government)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenues	31,9	33,6	31,7	31,2	30,7	-2,9
- Taxes and social security contributions	27,2	27,6	26,6	26,2	26,0	-1,6
- Other (residual)	4,7	6,0	5,1	5,0	4,7	-1,3
Expenditure	34,4	36,3	35,4	34,5	33,7	-2,6
- Primary expenditure	33,6	35,5	34,6	33,7	32,8	-2,7
of which:						
Gross fixed capital formation	4,9	5,7	5,0	4,9	4,7	-1,0
Consumption	12,1	12,4	12,1	11,6	11,2	-1,2
Transfers & subsidies	16,8	17,5	17,4	17,1	16,9	-0,6
Other (residual)	-0,2	-0,1	0,1	0,1	0,0	0,1
- Interest payments	0,8	0,8	0,8	0,8	0,9	0,1
Budget balance	-2,6	-2,7	-3,6	-3,3	-3,0	-0,3
- Cyclically adjusted	-2,7	-2,1	-3,0	-2,9	-3,0	-0,9
Primary balance	-1,8	-1,9	-2,8	-2,5	-2,1	-0,2
Gross debt level (central government)	27,9	31,9	30,5	32,2	33,5	1,6

Source: Pre-Accession Economic Programme (PEP) 2013. Figures for 2012 are based on the Finance Ministry's projections from mid-2012.

The government's fiscal strategy consists of lowering both the tax burden and public spending. The revenue-to-GDP ratio for the general government within 2013-2015 is lowered by 2.9 percentage points of GDP compared to 2012, while total spending is reduced by 2.6 percentage points. The reduction in total revenues is frontloaded while the spending reductions are more evenly distributed over the programme period. The tax burden is reduced mainly by keeping revenues constant in nominal terms. However, revenue from social contributions is expected to rise somewhat, with its share in GDP remaining broadly constant. On the spending side, the authorities intend to lower the share of primary spending by 2.7% of GDP between 2013 and 2015. The resulting general government deficit is expected to decline from -3.6% of GDP in 2013 to -3.0% in 2015. Given rather low growth, these deficits would lead to an increase in the debt ratio by some 3 percentage points of GDP. The authorities do not provide concrete information on how these objectives would be achieved.

In practice, the government's fiscal policy tends to be short-term oriented, adopting often insufficiently discussed short-term discretionary measures, such as tax relief for troubled companies with substantial payment arrears. Actual budgets and their implementation tend to deviate from the medium-term strategy, for example envisaging increased revenues despite the official objective of lowering the tax burden, or by lowering allocations for public investment in order to be able to raise social transfers. Furthermore, in contrast to legal obligations, the authorities neither adopted a medium-term fiscal strategy nor an update of the public investment programme.

The central government budget for 2013 is again based on optimistic revenue estimates. The budget for 2013 envisages a deficit of 3.5% of GDP, which compared to the realised deficit in 2012 is a slight reduction by about ¼ percentage point. This decline is the result of an increase in expected

revenues by ½ percentage point of GDP, while spending will be raised by ¼ percentage point only. This scenario is based on nominal GDP growth of some 5½%. Compared to the budgetary realisation in 2012, this implies an increase in revenues by some 7¼%, while spending is envisaged to increase by 6¼% year-on-year. On the revenue side, taxes are supposed to be the main source for revenue growth, while the spending side envisages a marked increase in spending for goods and services and social transfers. The share of capital investment would be reduced by 0.2% of GDP compared to 2012. The government has secured financing for its targeted fiscal deficit through a loan from a foreign commercial bank, partially guaranteed by the World Bank.

Box II.2.1: The budget for 2013

* Adopted by Parliament on 24 December 2012.
* The target for the central government budget balance is 3.5% of GDP.
* The budget is based on 2% real growth and inflation of 3.5%

Main measures in the budget for 2013

Revenues*	**Expenditure measures****
VAT revenues (+1.1% of GDP)	Transfers (+0.8% of GDP)
Social contributions (+0.2% of GDP)	Intermediate consumption (+0.5% of GDP)
Excise taxes (-0.2% of GDP)	Capital spending (-0.1% of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: Ministry of Finance

During 2014-15 the government intends to reduce the deficit to 3% of GDP. The authorities plan to lower the tax burden by 1 percentage point of GDP, while spending will be reduced by 1.7 percentage point, resulting in a drop in the deficit from 3.7% of GDP in 2013 to 3.0% in 2015. The financing should come mainly from international sources, although the authorities expect an increasing interest of domestic lenders in government bonds.

The short-term orientation of fiscal policy and weak administrative capacities have a bearing on the quality of public finances. The share of current expenditure, and in particular of spending on social transfers and subsidies in total spending, has not receded over recent years to the benefit of capital spending. The share of investment in GDP has remained at some 3¾% of GDP, while the share of social transfers and subsidies has been increasing. The ratio is also declining for areas set out as key strategic reform challenges, such as education.

Public debt is set to increase further, while the presented data lack transparency. As a result of the government's deficit spending approach, the central government debt has increased by some 10 percentage points of GDP since 2008. The presented fiscal framework envisages a further increase in government debt and does not present plans on how to contain this trend. The debt of state-owned companies, such as the electricity producing company or the railway company, probably adds another 5 percentage points of GDP to the public sector debt, which might bring general government debt close to 40% of GDP. As the government relies increasingly on non-domestic sources to finance its budget, the external part of the debt stock is projected to rise further in the medium-term. Although

the government has secured itself advantageous terms of its foreign borrowing in the recent past, the development of the external debt stock deserves enhanced attention.

Box II.2.2: Debt dynamics

Table II.2.4 :
Composition of changes in the debt ratio (% of GDP)

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**27,9**	**31,9**	**30,5**	**32,2**	**33,5**
Change in the ratio	3,6	4,0	-1,4	1,6	1,4
Contributions [2]:					
1. Primary balance	**1,7**	**1,9**	**2,9**	**2,5**	**2,1**
2. "Snow-ball" effect	**-0,7**	**-0,1**	**-0,7**	**-1,0**	**-1,1**
Of which:					
Interest expenditure	0,8	0,8	0,8	0,8	0,9
Growth effect	-0,6	-0,1	-0,6	-0,9	-1,1
Inflation effect	-0,8	-0,7	-1,0	-0,9	-0,8
3. Stock-flow	**2,5**	**2,2**	**-3,4**	**0,1**	**0,4**

Notes:
[1] End of period.
[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accru
Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations

While the government debt level is still moderate, past and projected rises give cause for concern. Central government debt amounted to 30.3% of GDP in the third quarter of 2012, and is foreseen by the government to rise to 33.5% by 2015. While a decrease in the ratio of over 1pp is foreseen for 2013, mainly reflecting the repayment of a Eurobond loan, continuous primary deficits will lead to a further increase in the debt ratio. The combined effect of interest spending, real GDP growth and inflation ("snowball effect") is expected to reduce the debt-ratio by an increasingly important share over the programme's horizon. Despite being on a declining trend, the planned primary deficits will result in a further increase in the debt ratio by some 3 percentage points of GDP during 2014 and 2015.

The fiscal framework still lacks consistency, transparency, and a medium-term strategy. The government recently proposed amendments to the Budget Law which aim at increasing transparency and accountability, by making the budget users explain their required strategic three-year plans in greater detail. Also, recently adopted legal changes provide for closer integration of public debt management and fiscal framework, so as to ensure consistency in the timeframe for adoption and in data used. However, these new requirements do not meet the key challenges identified in the public finance domain. Fiscal policy continues to suffer from weak planning capacities and a deteriorated recording of payment obligations. While the PEP gives some indications of spending priorities, their implementation would need to be detailed in a medium-term fiscal strategy, which, in spite of legal obligations, the authorities so far have not yet adopted. Presented data suffers from inconsistencies and from a lack of transparency and comparability to ESA 95 standards.

2.3. STRUCTURAL REFORMS

Envisaged reform measures seem in line with the challenges, but targets and implementation are not well specified. The government identifies as main reform challenges the reduction of unemployment and the promotion of actual and potential growth via higher value added production and a better qualified workforce. In line with these challenges, planned and on-going reforms are focused on targeted reduction of structural and youth unemployment; improved registration of employment; promotion of business climate, innovation, entrepreneurship and SMEs; human capital; rule of law; FDI and exports; as well as more efficient public services, improved regulatory supervision, while a bulk of measures also targets agriculture. There is, however, little information provided on the implementation details of the reform measures. The presentation would also have benefitted from performance-related information, by including details on expected effectiveness and efficiency, or by providing numerical targets of what the measures are expected to achieve, and the results of economic impact assessments.

Labour market reforms are focused on skills-improving ALMP and would benefit from also tackling wider structural measures. The bulk of expenses earmarked for reforms would rightly go towards labour market policies and education, with a gradually increasing net impact on the budget between 2013 and 2015. In this context, the programme provides information on an impact analysis of its active labour market programmes, conducted by the ILO in 2012, bolstering the government's decision to continue the implementation of these measures. On-going and intended reforms target key aspects of the labour market challenges, such as improving the education system at all levels; setting up retraining programs and promoting self-employment. Although few implementation details are provided, a priori these measures can contribute to tackling the challenges of combatting youth and long-term unemployment by attaining higher skills levels, and improving the matching of skills and needs in the job market. Yet, more effort is needed in meeting profound structural challenges of the labour market, such as improving the business environment, increasing overall employment and enhancing the registration of previously unregistered employment (about 25% of total), so as to release the labour market's full potential for supporting the government's growth and employment strategy. While some policy programmes are targeted at these issues, their endowment seems limited and implementation details are unclear.

Improving the business environment would support the government's growth and employment strategy and thus remains a complementary pillar in efforts to tackle labour market challenges. While the government continues in its efforts to facilitate business establishment and investment ("one stop shop" registration as a mid-term policy agenda item), it remains key to improve the efficiency of business-related administrative services on the one hand, and to step up efforts in supporting innovative activities of new and established companies. While the reform agenda foresees several funds and administrative measures in this area, again, actual implementation - in particular whether and how funds are put at the disposition of business, or whether they are used for financing administrative capacities - remains unspecified. Successful innovation and improved competitiveness in higher-value markets would not only support the necessary diversification of the export base, but would contribute to tackling structural unemployment by enhancing professional skills.

Annex: Overall Assessment of Programme Requirements

Macro framework

The programme presents a review of recent macroeconomic developments and an outlook for the medium-term, as requested by the Commission. It is largely based on the most recent available data at the time of drafting. As requested by the Commission, the authorities present an analysis of the external position, including development and breakdown of gross external debt and evolution of price/cost competitiveness.

Fiscal framework

The PEP does not present a medium-term fiscal strategy, although, compared to previous PEPs, it provides some indications on mid-term spending priorities. For 2013 and beyond, the PEP does not contain information on intended revenue and expenditure measures and their likely budgetary impact. Overall, the provided data is insufficiently reliable. Comparability with ESA 95 classification is limited. The authorities failed again to submit a fiscal notification, rendering it difficult to compare published data with benchmarks according to EU accounting standards. Furthermore, the analysis is impeded by the use of mid-2012 budgetary estimates, which still were far too optimistic. By September 2012, the authorities had announced to increase the 2012 deficit target to 3.5% of GDP, which was not included in the PEP. Moreover, the provided deficit and debt data do not distinguish clearly between central and general government debt.

The presentation on the financing of the deficit would have benefitted from an analysis of on-going efforts to strengthen the domestic debt market, in particular to issue longer-term bonds. No information on the maturity structure of external public debt is provided. The authorities provide a brief analysis of cyclically adjusted balances, assuming a closing of the output gap by 2015 – a year later than assumed in the previous PEP. However, more information on one-off- and temporary measures would be useful in order to calculate the structural balance, and to gage more accurately the impact of discretionary fiscal measures on the economy.

Structural reforms

While the authorities do not explicitly elaborate on structural obstacles to growth, they provide a list of on-going and planned policy measures in a large number of areas. However, the presentation would have benefitted from information on intended targets and expected results, and from a clearer breakdown of intended financing and actual implementation. It is not clear to what extent budget funds and funds from IPA and official donors would be supplemented by credit financing and/or FDI. This makes it difficult to assess the impact of structural reforms on the public debt and on external debt, in particular in the area of transport and energy projects. On labour market policies, more concrete target and implementation details would provide a better indication of their potential impact on unemployment. Unlike the previous year's programme, this year's document includes a table providing insights on the net budgetary impact of individual reform measures by policy area.

3. MONTENEGRO

Executive Summary

After two years of moderate growth the economy entered into recession with real GDP contracting by 0.5% in 2012. Due to its small size, limited economic diversification and high openness, the country is particularly dependent on the external environment. The sharp fall of international metals prices over 2012 exacerbated the structural problems of the aluminium industry while unfavourable weather conditions impacted severely energy and agricultural production. Despite weak domestic demand, inflationary pressures increased driven by excises and services duties which were increased to cope with budgetary shortfalls, and by the revision of electricity tariffs. Overall, domestic demand remains subdued due to tight credit conditions, limited fiscal space and stagnant employment levels.

A stabilised but still fragile banking sector with a high level of impaired loans poses a risk to economic stability. The consolidation of the banking sector has continued but additional efforts are required. The reduction of non-performing loans (NPLs) remains a key factor to enable the recovery of the intermediation role of banks. Overall, after a significant overhaul of legislation in the last years, the authorities must focus their efforts on facilitating the restoration of liquidity to the economy.

A high fiscal deficit and rising public debt calls for further fiscal adjustments. The fast increases in fiscal imbalances and public debt have proved difficult to tackle. In 2011 and 2012 the deficit targets were missed by a broad margin. Despite increases of excises and social security contributions, revenue collections dropped markedly. Moreover, a rather rigid structure of non-discretionary commitments on the expenditure side of the budget and the call of contingent liabilities added to the general government deficit during these two years. The general government deficit reached 4% of GDP in 2012 and public debt surged from 41% to 51% of GDP within two years.

The labour market suffers from structural unemployment and low participation rates, reflecting the unfinished transformation of the economy. Job creation is not yet sufficient to cope with a legacy of industry layoffs. High rates of long-term as well as youth unemployment point to the persistence of market rigidities; while the market for non-resident employment adjusts more efficiently. Job creation also displays a strong seasonal pattern, with employment growing during the tourism season and falling back at the end of each year. Overall, the structure of unemployment suggests that appropriate labour market policies should be a priority for supporting employment.

External imbalances are still substantial and a source of vulnerability. Since the start of the crisis, the current account deficit has contracted markedly driven by a substantial reduction of the external trade gap and the gradual increase of surpluses in services. However, at around 20% of GDP, the current account deficit remains extremely high and bringing it to sustainable levels may take years to achieve. External imbalances remain a structural issue as the widening services surplus cannot compensate for the very large trade deficit, the overall volume of imports being still twice that of exports. In the virtual absence of monetary policy tools, improving external competitiveness will rely on the continuation of structural reforms with a view to raise labour and capital productivity.

The heavy reliance on external financing remains a cause of concern. The economy is exposed to significant financing requirements to cover the current account deficit as well as the amortization of external debt (both long and short-term). So far, external financing has been secured through foreign direct investment (FDI), unrecorded transfers related to tourism, and a successful rollover of maturing external obligations. However, uncertainties in the Eurozone and on a global scale could constrain capital inflows and imply significant debt roll-over and refinancing risks going forward.

3.1. ECONOMIC OUTLOOK AND RISKS

The programme expects a resumption of economic growth. GDP is projected to reach 2.5% in 2013, and progressively accelerate to 3.5% in 2015. Private consumption is set to decelerate progressively while the growth rate of gross fixed capital formation will slow down in 2014 to step up in 2015, also on the back of stronger public investments. Government consumption growth is projected at above 1% for 2013 and 2014, before it accelerates to 3% in 2015. Net exports are forecast to have a positive contribution to growth only in 2013 due to the sharper contraction of imports compared to exports. In 2014 and 2015, the exports rate of growth should recover at a faster pace than that of imports, providing a positive although very modest contribution to growth.

In contrast with the programme, the Commission Winter forecast (until 2014) expects tax increases in 2013 to have a more negative impact on domestic demand while the contribution of net exports will remain negative, although the current account deficit would stagnate (rather than decline) as foreign direct investments should remain highly import dependent. By contrast, the Commission also expects higher private consumption levels due to a slightly faster financial intermediation recovery, lower government spending, and a gradual acceleration of investments (without slowing down in 2013) and therefore, slightly lower unemployment rates that foreseen in the PEP.

Table II.3.1:

Comparison of macroeconomic developments and forecasts

	2011		**2012**		**2013**		**2014**		**2015**	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	3,2	**3,2**	0,2	**0,5**	2,2	**2,5**	3,0	**3,0**	n.a.	**3,5**
Contributions:										
- Final domestic demand	0,9	**0,9**	2,1	**0,9**	3,0	**3,7**	4,1	**2,6**	n.a.	**3,1**
- Change in inventories	-0,6	**-0,6**	-0,1	**-1,1**	0,0	**0,0**	0,0	**0,0**	n.a.	**0,0**
- External balance of goods and services	2,9	**2,9**	-1,8	**0,7**	-0,9	**-1,2**	-1,2	**0,4**	n.a.	**0,4**
Employment (% change)	-6,4	**-6,4**	0,8	**0,8**	1,0	**1,9**	1,4	**1,0**	n.a.	**1,5**
Unemployment rate (%)	19,7	**19,7**	20,0	**22,7**	19,7	**21,2**	19,4	**20,6**	n.a.	**19,6**
GDP deflator (% change)	0,9	**0,9**	3,9	**2,3**	2,1	**2,5**	2,3	**2,5**	n.a.	**2,5**
CPI inflation (%)	3,1	**3,1**	4,1	**4,0**	2,7	**2,7**	2,5	**2,5**	n.a.	**2,5**
Current account balance (% of GDP)	-19,6	**-19,6**	-20,0	**-20,0**	-20,6	**-21,0**	-20,6	**-20,4**	n.a.	**-19,7**

Sources: Pre-Accession Economic Programme (PEP) 2013, Commission Winter 2013 forecast (COM)

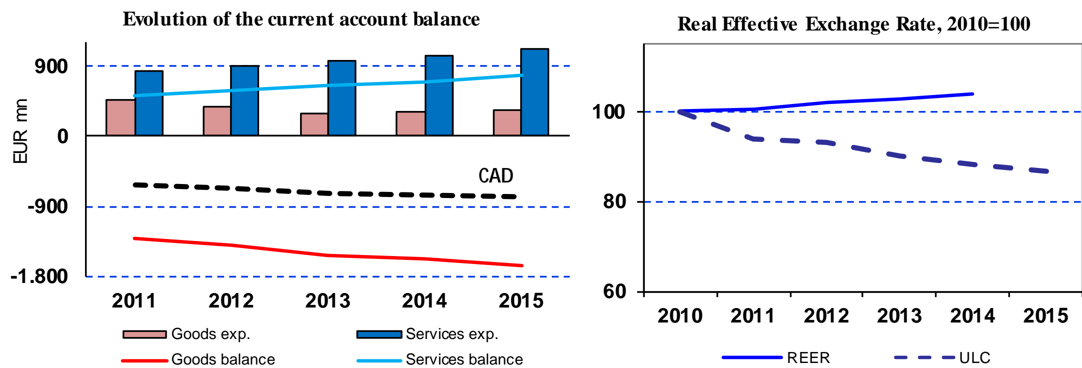
Risks to the outlook for price stability are broadly balanced. Slow credit growth and subdued domestic demand set the scenario for moderate inflation, although with a slightly higher pace in 2013 than in the outer years due to base effects of some one-offs increases in 2012. This scenario relies on the moderation of energy and food prices and a stable exchange rate of the euro against the US dollar. The increase in the personal income tax in 2013 could have an effect on private consumption and thus further reduce price pressures. Import prices (notably on energy and food products) are likely to determine to a large extent price dynamics given weak domestic-driven inflationary pressures.

The difficult labour market conditions hamper both the short and medium term growth prospects. The domestic labour market will continue to struggle with high unemployment rates, a high share of long-term unemployed and weak labour force participation. The unemployment rate should slightly decrease below 20% as employment records marginal growth. The high proportion of youth unemployment points to a persistent skill mismatch between supply and demand in the labour market. In addition, the employment of foreign workforce for low-skilled seasonal jobs suggests that there are disincentives for local workers.

Low diversification of the economy and high import needs confirm the structural nature of the current account deficit. The current account deficit is basically driven by the trade balance. Merchandise exports are expected to further decline in 2013 following the decision to halve aluminium production. Exports would reaccelerate in the outer years supported by steel and electricity, growing at a faster pace than imports. Meanwhile, balance of services surpluses are expected to continue gradually growing, reducing marginally the current account deficit. However, the external gap is set to remain very large in the next years (close to 20% of GDP([2]). The country will thus remain highly dependent on external finance, and as such, vulnerable to changes of investors' sentiment.

Strong FDI inflows are expected to continue financing external requirements. FDI have a very high import content and contribute to the large current account deficit. The external deficit net of FDI is substantially lower at 4% of GDP, mainly financed through unrecorded transfers related to tourism. As seen in the past, foreign investments -particularly in tourism and energy projects- present good prospects in the coming years and are projected to remain strong, with double digit annual growth rates. These investments will support the diversification of the economy and increase export potential.

Graph II.3.1 : **External competitiveness and Current account**



Source: Pre-Accession Economic Programme (PEP) 2013, Commission services

Restoring banking sector stability remains challenging. Banks have significantly downsized their balance sheets since 2008 in response to the run on deposits at the onset of the crisis. Since then, confidence in the banking sector recovered. However, as deposits began to stabilize, flows from foreign parent banks have reversed and lending remains anaemic. Total loans have contracted for four consecutive years, although at a declining rate. The reduction of non-performing loans (NPLs) remains a key factor to enable the recovery of the intermediation role of banks. Although this rate has moderated from a high of 26% of gross loans in June 2011, thanks to the sale of impaired loans to parent banks or factoring companies, the ratio has remained persistently high, at around 17% until the end of 2012, and represents both a risk for some banks as well as an obstacle to credit growth. The Central Bank has launched a program in cooperation with international financial institutions (IFIs) for restructuring loans and reducing the high level of NPLs. Banks liquidity ratios have remained above minimum requirements levels, but their profitability remains largely negative.

([2]) Recent data revision by the Central Bank of Montenegro reduces the deficit by 2.2 percentage points of GDP after adjustments on the balance of services and financial accounts. According to this, CAD would be -17.7% of GDP in 2011 and 2012 instead of -19.6% and 20% respectively in the table above.

Table II.3.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	3.296	3.132	2.941	2.898	2.807
Foreign ownership of banking system	79,9	81,3	82,9	82,9	81,9
Credit growth	24,6	-14,3	-8,2	-11,1	-4,8
Bank loans to the private sector %	96,3	94,7	94,0	90,3	91,7
Deposit growth	-4,8	-8,3	-1,9	1,5	9,0
Loan to deposit ratio	1,4	1,3	1,2	1,1	0,9
Financial soundness indicators					
- non-performing loans	7,2	13,5	21,0	15,5	16,9
- net capital to risk weighted assets	15,0	15,8	15,9	16,5	14,7
- liquid to total assets	11,2	15..26	19,1	19,9	24,0
- return on equity	-6,9	-7,8	-27,3	-1,1	-18,3
- forex loans to total loans %	3,9	4,0	4,1	2,3	1,9

Sources: National Central Bank, Ecowin/Reuters

Overall, the mid-term macroeconomic programme presents an optimistic scenario given the uncertainties in the external environment and the unresolved problems in the metals sector. A deterioration in the Euro area could have negative spill over effects on FDI, trade and financial flows, while a worsening of the situation of the aluminium company (KAP) would reduce exports further. Fiscal consolidation could have a deeper than expected negative impact on domestic demand, should the recession persist. However, on the upside, due to the small size of the economy, new investment projects can have a large positive impact.

3.2. PUBLIC FINANCE

The deterioration in the general government deficit in 2012 reflects the worsening of macroeconomic conditions. Major revenue shortfalls at the beginning of the year, in particular from VAT and social security contributions, required an urgent revision of the budget in April. The revised budget included additional expenditure cuts and increases of several fees. The rebalanced budget was broadly established along the lines of the alternative low-growth scenario presented in the previous PEP, which facilitated a rapid reaction. Some improvement during the second half of the year, notably from higher than planned revenue from corporate income tax and social security contributions were offset by the unexpected activation of a state guarantee to the aluminium company at a cost of 1% of GDP. The general government deficit reached 4.0% of GDP in 2012, significantly higher compared to the 2.4% deficit target of the revised budget.

The main goal of the fiscal strategy remains the consolidation of public finances. So far fiscal tightening has focused on capital spending, gross salaries, current maintenance and subsidies. However some slippages in 2012 on pensions (due to early retirement of military staff in preparation for NATO accession) and rising interest payments required the introduction as of 2013 of additional measures on the revenue side too. The medium-term budget framework has been reinforced with the

introduction of some temporary([3]) tax increases, as well as with a programme for the reduction of tax arrears, and another for the expansion of the tax base by tackling informality.

The introduction of fiscal rules would be instrumental in anchoring fiscal consolidation and expectations. After a significant deterioration in the budget deficit in 2009 the government engaged into fiscal consolidation. However, the weakening of activity and deleveraging of the private sector have led to repeated overrun of targets and the build-up of arrears. Moreover, the support to the corporate sector was done through state-guaranteed debt, increasing contingent liabilities. The programme schedules the adoption of a law on budget and fiscal responsibility in 2014, and considers several possible fiscal objectives. If properly designed and implemented, with a clear primary target and path towards its attainment, a fiscal rule would likely improve the quality of public finances in the medium-term.

The 2013 budget presents further consolidation efforts. The government has started adjusting its short-term fiscal policy to fiscal pressures early in 2013 through a set of austerity measures, including a freeze of pension indexation, a temporary crisis tax on wages, limitations of salaries for members of the board of public enterprises and the reduction of salaries of the members of the parliament. However, depending on macroeconomic developments, further additional fiscal measures (not included in the programme) could be needed to achieve the deficit target.

Box II.3.1: The budget for 2013

* The establishment of a new government at the beginning of December 2012 resulted in some delays in the elaboration of the budget law for 2013, which was finally adopted by the parliament on 28 December.
* The target for the general government deficit has been revised to 2.3% of GDP, compared to estimations of a practically balanced budget in the previous year's PEP.
* Both revenues and expenditures are reduced compared to the previous year rebalanced budget, by 1.5 and 2.3 percentage points of GDP respectively. Capital expenditures should remain at the same level as in the previous year (3% of GDP).
* Main fiscal measures are focused on: improving revenue collection through additional tax reforms (personal income tax, duties and excises), the broadening of the tax base via the reduction of the grey economy and additional expenditure savings.
* The Ministry of Finance coordination team for the reduction of the grey economy will strengthen controls in four areas: excise goods trade, retail trade records, labour market, and undeclared economic activities. Controls are combined with a more rigid penalty policy.

([3]) Increases are presented as temporary crisis measures as the government remains committed to maintaining a competitive tax environment for attracting investors. The only permanent increases would be those, like excises, requiring further alignment in the context of the EU accession process.

Main measures in the budget for 2013

Revenue measures*	Expenditure measures**
Increase of the personal income tax rate by 6 pps to 15% for net salaries above country average (+0.3% of GDP)	Expenditure cuts (-2.3% of GDP)
Law on duties for access to services of general interest (+0.3% of GDP)	Restrictive public employment policy
Increase of excise rates (alcohol, tobacco, oil)	Freezing of pensions at nominal level
Programme for reduction of tax arrears	Reduction of salaries for members of parliament and members of state-owned companies boards
Tax base broadening (fight against grey economy)	One off subsidies to beneficiaries of social assistance
Increase of income upper ceiling exempted of social security contributions (+0.1% of GDP)	Adoption of the Law on Budget and Fiscal Responsibility (i.e. fiscal rules). (full implementation only in 2014)
Transfer of budget surpluses of regulatory agencies and central bank to the central budget	
Privatisation receipts (+0.6% of GDP)	

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Sources:.Pre-Accession Economic Programme (PEP) 2013

Over the medium term, the budget should come close to balance. Overall, a substantial fiscal adjustment would take place in the period 2012-2015 (see table), although the fiscal framework lacks a description of the underlying fiscal and structural reform measures to support the spending and deficit reductions. General government expenditures will be reduced by 5.4 percentage points of GDP (from 41.7% of GDP in 2012 down to 36% in 2015) thanks to the continuation of expenditure cuts on goods and services. Public sector salaries will be frozen in nominal terms, while capital spending and pensions should be contained in real terms, presenting constant levels of 3% and 11% of GDP, respectively, in the period 2013-2015. Budget revenues will decline, but at a slower pace than expenditures, to reach 35.6% of GDP in 2015. Overall, by 2015 the budget should present a deficit of 0.7% of GDP with already a primary surplus in 2014 of 0.7% of GDP, rising to 1.9% in 2015.

Table II.3.3:

Composition of the budgetary adjustment (% of GDP)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenues	39,7	38,6	37,1	36,0	35,6	-3,0
- Taxes and social security contributions	33,6	33,3	31,8	31,3	30,9	-2,4
- Other (residual)	6,1	5,3	5,3	4,7	4,7	-0,6
Expenditure	45,2	41,7	39,4	37,7	36,3	-5,4
- Primary expenditure	43,7	39,9	37,3	35,3	33,7	-6,2
of which:						
Gross fixed capital formation	4,2	3,4	3,0	2,9	2,9	-0,5
Consumption	23,9	20,7	20,5	20,2	20,5	-0,2
Transfers & subsidies	15,5	15,0	14,7	14,3	13,9	-1,1
Other (residual)	0,1	0,8	-0,9	-2,1	-3,6	-4,4
- Interest payments	1,5	1,8	2,1	2,4	2,6	0,8
Budget balance	-5,5	-3,1	-2,3	-1,7	-0,7	2,4
- Cyclically adjusted*	:	:	:	0,2	:	:
Primary balance	-4,0	-1,3	-0,2	0,7	1,9	3,2
Gross debt level	44,4	52,1	54,5	54,3	51,7	-0,4

Sources: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations.
** The programme provides a chart but no figures on structural balances except for 2014*

The composition of spending is set to remain unchanged in the medium-term. Social security transfers (80% of which represent pensions) will continue to account for 37% of total expenditures. Additional 29% of expenditures refer to public sector wages, while interests and subsidies add 6% and 1% of total spending respectively. According to the programme, budget discipline should be enhanced through the adoption of savings and rationalisation measures including the reform of maternity allowances and better targeting of social welfare benefits. The capital budget appears modest (around 7% of total expenditures or 3% of GDP) but a substantial part of investment in infrastructure is implemented through FDI and loans from international financial institutions (i.e. public debt) rather than from the capital budget. On the revenue side the government remains committed to a competitive low level of taxation in order to attract investment. Therefore, most tax increases adopted in 2012 and 2013 are temporary and expected to expire in 2014.

However, several risks threaten public finances stability. The programme itself identifies several potential risks: the calling of state guarantees, an increase of tax arrears, an increase of the informal economy (with reduction of the tax base), or the preclusion from international capital markets. However, their fiscal impact is not estimated. The risks related to KAP deserve special attention given their magnitude and the high probability of activation of state guarantees. The government, as co-owner of the company, would be liable for at least 30% of this company's debt estimated at EUR 350 million (or some 10% of GDP). Another risk lies with the continuous growth of pensions, which account for 29% of the budget, and an unfavourable ratio of just 1.9 employed per pensioner. Although the PEP fiscal adjustment relies heavily on a sustained freeze of pensions and public sector salaries, these measures could prove to be politically difficult to sustain in future. Going forward, deeper structural reforms of the pension and public wage systems should address issues of sustainability and fairness.

Box II.3.2: Debt dynamics

Public debt should peak in 2013 and stabilise in 2014 to start declining in 2015 as positive primary balances turn on and budget financing needs decreases stock flow adjustment.

Interest payments will continue increasing steadily, from 1.8% of GDP in 2012 to 2.6% by the end of 2015. Yet, the reliance of debt dynamics on growth developments may result in a higher increase of the debt ratio to GDP in case that the annual outcome of growth fell short of the programme's projections.

Table II.3.4:

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

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**44,4**	**52,1**	**54,5**	**54,3**	**51,7**
Change in the ratio	3,5	7,7	2,4	-0,2	-2,6
Contributions [2]:					
1. Primary balance	**4,0**	**1,3**	**0,2**	**-0,7**	**-1,9**
2. "Snow-ball" effect	**-0,2**	**0,6**	**-0,4**	**-0,5**	**-0,5**
Of which:					
Interest expenditure	1,5	1,8	2,1	2,4	2,6
Growth effect	-1,3	-0,2	-1,2	-1,5	-1,8
Inflation effect	-0,4	-1,0	-1,3	-1,3	-1,3
3. Stock-flow	**-0,3**	**5,1**	**2,6**	**1,0**	**-0,2**

Notes:

[1] End of period.

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

Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations

Public debt has been rising, but exchange rate and liquidity risks appear modest. Debt levels practically doubled in the period 2008-2012, from 27% to 51% of GDP, driven by rising budgetary financing needs. However, the currency risk is low as most of the debt is in euros and its terms favourable with an average interest rate at 4.6% and long repayment periods with average maturity of 6.7 years at the end of 2012. Yet, some 22% of the total debt would need to be rolled over in the next three years as Montenegrin Eurobonds mature unless the government reach an agreement with bondholders on the extension clause option (currently under negotiation). Although public debt sustainability is not an immediate concern, contingent liabilities present a significant risk. State guarantees represented 11% of GDP at the end of 2012. One third of these relates to one company (KAP). To avoid excessive exposure, the government intends to restrict the issuance of new guarantees to key infrastructure projects presenting a positive economic growth impact or limited risk. Meanwhile, fiscal consolidation should support the build-up of primary surpluses to reduce the stock debt over the medium term.

3.3. STRUCTURAL REFORMS

Montenegro is confronted with a general problem of competitiveness compounded by the negative spill-over effects from the crisis. The country's potential is hampered by weaknesses such as an insufficient diversification, a problematic industrial heritage, high youth and long-term unemployment rates or the reliance on weather conditions for energy, agriculture and tourism performance (three key sectors of the economy), as well as a high exposure to exogenous risks like energy and commodity prices shocks or foreign parent banks sentiment. The PEP presents structural reforms as a condition for overcoming the effects of the crisis and, in the long run, for creating a competitive environment. Most reforms envisaged in the programme appear reasonably appropriate to tackle the country's structural weaknesses; although their effectiveness cannot be assessed as underlying policy measures and their expected impact are not made explicit.

The stabilization of the financial sector remains critical to sustain the economy. Further reforms of regulation and supervision to improve internal bank controls and credit risk management is being implemented by the Central Bank. After the recent adoption of decisions for calculating bank exposures and for credit risk management in banks allegedly according to EU Directives, the calculation of the banks' regulatory capital and provisions according to international accounting

standards was introduced in 2013. Further reforms will continue on strengthening minimum standards for liquidity risk management, management of concentration risk and further stress testing. The process of further harmonisation with EU legislation will be sped up.

Structural problems in the industrial sector need to be efficiently addressed. While the restructuring of the steel company was successfully completed, the aluminium plant remains a critical issue. The company represents a significant drain on fiscal, labour and energy resources. It threatens the stability of public finances as well as the solvency of its creditors and suppliers. The future of the company remains quite uncertain. The plan of the government is to stabilise the factory by halving the production and workforce to reduce costs and to stop imports as well as direct subsidisation of electricity with a view to finding some investor to take over.

Energy appears as a bright spot. The plans for new investments in a number of electricity power plants represent an opportunity for diversifying the economy and improving competitiveness, while removing the current constraints of energy supply for investors and SMEs. Furthermore, the recent reforms of the energy market and the establishment in 2013 of a regional auction office in Montenegro, together with the interconnection project with Italy, should allow the country to become an export hub.

The reform of the transport sector represents risks as well as opportunities. Restructuring, privatisation and concession tenders are underway for the railways, port of Bar, shipyard and airports. Investors could help to improve the competitiveness of these sectors with a positive impact for the rest or the economy. The road sector presents a particular case with the announced construction of the highway section Podgorica-Mateševo, with planned investments of EUR 500 million (or 14% of GDP) over 5 years. However, given the constrained fiscal space, the financing options for these large projects should be very carefully considered.

Knowledge, skills and education are central for productivity gains. Improving the quality and efficiency of education requires modernizing higher education and tailoring practical skills and vocational training as well as lifelong learning to private sector demand. The PEP provides little specificity on labour market reforms, although advancing labour market reforms to increase flexibility remains critical. So far, measures have focused on some punctual actions like job subsidisation for university graduates as well as young seasonal workers and some vocational training organised with the employment agency. These measures are not sufficient to invigorate the labour market. Further reform of the education and vocational training systems has been delayed due to budgetary constraints. The programme's ambition seems limited. It foresees to resume with the preparation of several studies and strategies concerning education quality and financing as well as aligning with labour market needs. However, the structure of unemployment suggests that further labour market reforms are still required for boosting employment and to prevent those with the highest potential from leaving the labour force.

There is scope for improving the investment climate, particularly at local level. The impact of local fees and taxes on communal services, delays in getting utility connections, or the need to speed up procedures for registration and transfer of property are some concrete problems that investors find at local level. After the recent establishment of one-stop shops for business registration and other measures at central government level, the measures of the programme focus on municipal permits, licenses and fees as well as implementing regulatory impact assessments of legislation on business environment. Meanwhile, the Investment and Development Fund continues supporting SMEs through subsidised loans, while the new Secretariat for Development helps removing administrative obstacles for larger investors.

Annex: Overall Assessment of formal requirements

Montenegro's second Pre-Accession Economic Programme (PEP 2013-2015)([4]) presents a comprehensive and broadly consistent outline of the medium-term macroeconomic and fiscal frameworks based on the projection of a resumption of growth in 2013 followed by a gradual acceleration in the outer years. The main objective remains unchanged compared to the previous PEP: to strengthen fiscal and financial stability as a prerequisite for long term economic growth. The document broadly complies with the Commission's requirements, and presents some improvement of analytical capacities. Although there is a visible effort to complete all the statistical requirements, there are still some data inconsistencies. Although the procedure for preparation of the PEP does not have a legal backing in Montenegro, it has de facto been integrated into the national fiscal programming exercises, and, in the last two years, the country's annual budget shares the same macroeconomic and fiscal frameworks as the PEP.

Macro framework

The PEP macroeconomic scenario fails to elaborate on the rationale underlying the development of some sources of growth as descriptions are mostly based on production factors. The external assumptions are partially based on the European Commission's autumn 2012 forecast, but without expectations on the international environment for the outer years. Analytical capacities are improving. The analysis of potential growth using the Hodrick-Prescott filter has been supplemented this year with the introduction of the Cobb-Douglas production function and total factor productivity study. According to this analysis, the economy is set to reach growth potential in 2015 driven by total factor productivity gains in agriculture (base effect), retail trade, tourism, transport telecommunications and banking, while capital contribution should stagnate. Labour contribution to growth is expected to remain insignificant.

The PEP also presents an alternative low-growth macroeconomic scenario focused on external factors (i.e. a mild deterioration of the Eurozone crisis affecting tourism, lending, FDI inflows, and exports). The scenario fails to consider some domestic risks, like the impact from liquidation of the aluminium factory (KAP) or, on the upside, from construction of major infrastructures.

Fiscal framework

The fiscal programme is broadly consistent with the macroeconomic framework, and sufficiently comprehensive, with the key measures on the revenue and expenditure side well identified and articulated in the budget for 2013. However, the PEP forewarns that additional measures -not included at the time of submission of the programme- are susceptible of being adopted later, as a new government took office shortly before the submission of the programme. The programme does not include any reference to the Progress Reports; even if the outline encouraged the authorities to include cross-references to the Commission's assessment. An estimation of worst-case scenarios could service the authorities for assessing the limitations of their baseline scenario as well as to prepare contingency plans and fiscal fall-back positions. However, the PEP low-growth fiscal scenario anticipates just a mild deterioration of the general government deficit (by 0.2 percentage points of GDP). The supplementary gap would be secured by additional external borrowing. Fiscal data is not in line with ESA95 standards, although the authorities are being reminded on several occasions of this requisite as candidate country (i.e. alignment with EU Directive 2011/85). Montenegro did not present a fiscal notification in 2012, although it has been encouraged to participate in next exercises.

([4]) Montenegro's programme is originally labelled 2012-2015 reflecting the year of government approval (2012) instead of the submission year (2013).

Structural reforms

To strengthen competitiveness the business environment should further improve. Building on recent improvements in a number of areas, the government intends to deepen the investment climate reforms by introducing regulatory impact assessments and by improving business procedures further, especially those concerning local entities and construction. The structural reform section presents an improvement with previous years, especially the streamlining and systematic analysis of the different measures. However the section still needs to identify and articulate clearly the obstacles to growth with the specific measures and policy priorities presented to solve them. The PEP systematically reports on reform implementation and reasons in case of divergence, and provides an evaluation of their fiscal impact (although often partial and mostly on the expenditure side). Further efforts are still require providing an estimate beyond the current budget year, and not only for the expenditures. The authorities recognise several difficulties; from a lack of a clear definition of structural reform, to insufficient institutional and human capacities in line ministries for estimating the impact of the reforms.

4. SERBIA

Executive Summary

A pattern of recessions and sluggish growth has been characterising the economy since 2009. In the pre-crisis period significant vulnerabilities had emerged since growth was based heavily on externally financed domestic demand, creating significant imbalances. Therefore, the authorities' strategy aims at a decisive shift to a new growth paradigm built upon the tradable sector and underpinned by a shift towards stronger investments and net exports. To support this shift, there is an urgent need to address the numerous obstacles to growth. Most of the structural weaknesses are recognised by the programme and measures to address them are either envisaged or in preparation. However, the timely implementation of these measures remains a key challenge and in order to bring credibility to the reform agenda, there is a need to operationalize the various reform intentions and design clear action plans for their implementation.

Serbia has narrowly escaped a fiscal crisis in 2012. In an election year, budget expenditures went off-track and the deficit overshot by far the initial target. The recently introduced fiscal rules proved weak and insufficient to guard fiscal performance and government debt exceeded significantly the 45% of GDP limit, reaching more than 60%. The new government took measures, mostly on the revenue side, but also increased some expenditure, keeping the deficit very high at 6.4% of GDP in 2012. A wide range of public finance reforms are expected to continue but the significant reduction of the deficit targeted in 2013 (3.6% of GDP) is very ambitious and will require additional adjustment measures. Over the medium-term, some savings in subsidies could be expected, in case the government follows on its commitment to finalise the restructuring of socially-owned enterprises. However, the process of reducing spending on wages and pensions, from their still very high levels, is likely to decelerate significantly after moving to inflation indexation, while aging population and budget pressures demand further reforms of the pension and health care systems. Overall, sustained efforts are needed to put public finances on a sounder footing, including structural reforms to reduce and restructure public expenditure in order to ensure sustainable fiscal adjustment and create more space for growth-enhancing expenditure.

Inflation remained elevated and volatile over the recent years, driven sharply upwards by a combination of supply side shocks from food prices, dinar depreciation and fiscal relaxation and, pushed downwards, once the shocks had passed, by base effects. The lack of clear and predictable pattern of adjusting administered prices created additional difficulties in controlling inflation. Addressing the web of food price volatility, dinar stabilisation in a highly euroised economy, proper macroeconomic policy mix, and administered prices has proven extremely challenging. However, the importance of these issues has been brought to the attention of the authorities, which are expected to undertake systemic measures to improve the functioning of the food market, determine a medium-term plan of administered price revisions, and consistently implement their fiscal consolidation programme. In addition, further measures to reduce state influence in the economy and administrative and regulatory barriers and strengthening competition and functioning of product markets would be needed to limit inflation volatility.

In 2012, labour market indicators reached a ten-year low. Only about one person in three above the age of 15 has been employed. The economy continued shedding labour, albeit at decelerating pace. The private sector saw the biggest drop in employment, while employment in the public sector remained largely intact, implying further hurdles down the road. Long-term and youth unemployment have been persistently high, revealing a fractured market and deep-seated structural weaknesses. To relieve the short-term pressures on the labour market, the government is planning some very limited measures to reduce rigidities. In addition, the envisaged improvements in the business environment

are expected to stimulate investments and employment creation. Plans to improve the allocation of the scarce budget resources to benefit those who are most in need and to implement the Strategy for Education Development are also steps in the right direction. However, further measures would be needed to address youth and long-term unemployment via active labour market policies and to prompt employment creation by giving due consideration to reassessing the structure of taxation by reducing labour taxation.

4.1. ECONOMIC OUTLOOK AND RISKS

Delays in implementing economic reforms pose the main risk to the macroeconomic scenario. The programme recognises the uncertainties stemming from both external and domestic environment. Tensions on the international financial and commodity markets and a fragile recovery of the euro area and regional economies could potentially sap exports' demand and foreign capital inflows. After years of delays, accelerating structural reforms to increase productivity and support a shift towards a more sustainable growth model holds the key towards improving the medium- and long-term outlook.

The programme foresees a mild recovery by 2% in 2013 and further acceleration of real GDP growth to 3.5% and 4% in the outer two years. Private and government consumption are expected to follow the same pattern, but to remain negative in 2013 and turn to a rather subdued growth in the next years. Steady growth of investments (8.2% on average over 2013-2015) and exports (10.3% on average) are the main engines of economic activity over the programme period. In line with the growth scenario, the labour market is set to bottom out in 2013 and slowly recover afterwards with limited gains in employment. Inflation is expected to decelerate as of the second quarter of 2013 and return within the inflation tolerance band by the end of the year. Thereafter, continuing fiscal consolidation, controlled increases of regulated prices, stable exchange rate and food prices are forecasted to support price stability. A key element of the programme is that, after peaking in 2012, external imbalances will be slowly receding.

Table II.4.1:

Macroeconomic developments

	2011		2012		2013		2014		2015	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	1,6	**1,6**	-1,7	**-2,0**	1,7	**2,0**	2,0	**3,5**	n.a.	**4,0**
Contributions:										
- Final domestic demand	0,8	**4,1**	-1,8	**-3,0**	-1,0	**-0,2**	2,0	**2,3**	n.a.	**3,0**
- Change in inventories	3,3	**0,0**	0,6	**0,0**	0,1	**0,0**	0,3	**0,0**	n.a.	**0,0**
- External balance of goods and services	-2,5	**-2,6**	-0,6	**0,9**	2,6	**2,2**	-0,3	**1,2**	n.a.	**1,0**
Employment (% change)	-6,0	**-6,0**	-1,1	**-4,5**	0,1	**0,0**	1,2	**1,9**	n.a.	**2,0**
Unemployment rate (%)	23,0	**23,0**	23,9	**26,2**	23,9	**26,0**	23,1	**25,3**	n.a.	**24,6**
GDP deflator (% change)	9,6	**8,5**	7,4	**5,0**	9,6	**10,4**	5,1	**4,5**	n.a.	**4,3**
CPI inflation, annual average (%)	11,1	**11,0**	7,3	**7,5**	10,2	**11,1**	5,4	**4,8**	n.a.	**4,5**
Current account balance (% of GDP)	-8,8	**-8,9**	-10,6	**-11,0**	-8,9	**-9,0**	-9,6	**-7,9**	n.a.	**-7,0**

Sources: Pre-Accession Economic Programme (PEP) 2013; for 2011 and 2012 the latest official national statistics where possible. Commission Winter 2013 forecast (COM)

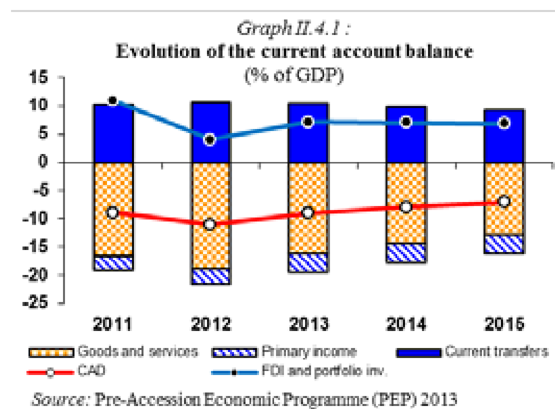
The macroeconomic scenario is plausible in 2013 and optimistic in the following two years. The authorities have correctly indicated that the numerous constraints supressing private consumption, from falling disposable incomes to stagnating employment, could start weakening only by the end of the period. A little less sanguine is their assumption that public consumption would revert to positive

trajectory already in 2014, when, if judged by major budget expenditure ratios, further significant fiscal consolidation efforts are expected. A major boost to growth in the outer two years is expected from the rather implausible assumption of a steady acceleration in exports growth.

Investment growth has seen significant volatility over the past years and its expected recovery may prove unstable. More crucially, increases in investments would depend on the speed and successful implementation of reforms improving the business environment and supporting private sector development. Depressed domestic demand would tend to stimulate investments in the tradable sector. However, in view of the fragile economic situation in the region and in the EU, and unfavourable financing options, this may be a slow process with limited results in the near future.

Exports are on an upward trajectory in 2013 but further acceleration faces constraints. The opening of a big car assembly factory has already had visible results in boosting overall exports performance in late 2012, with its full impact expected in 2013 when exports' growth could reach double-digit level. Maintaining and even further accelerating this growth, as envisaged in the programme, could be extremely challenging, as both the investment cycle and structural reforms, on which this assumption is based upon, are likely to take more time to generate tangible results.

Graph II.4.1 :
Evolution of the current account balance
(% of GDP)



Source: Pre-Accession Economic Programme (PEP) 2013

External imbalances would not unwind easily. Despite having been through two recessions in four years, and indicative of deep-rooted structural problems, the economy is still facing significant external imbalances. While exports are set to contribute to an important adjustment in the trade deficit in the short-term, what could drive this process further is less clear. As domestic demand, investments in particular, recovers, especially in the last two years of the programme, imports are expected to turn to robust growth as well. Following three years of exchange rate depreciation in 2008-2010, which helped the downward adjustment of external imbalances, the real effective exchange rate appreciated in 2011 and 2012. Further appreciation, as implied by the programme scenario, will not be conducive to the foreseen continuous reduction in external imbalances. Servicing the higher foreign indebtedness and income outflows related to FDIs are also likely to be pushing the current account deficit upwards.

Labour market adjustment is expected to continue, following the announced public sector restructuring. While unemployment may have hit the bottom at 24% in 2012, it remains a grave policy concern. With rebounding economic activity in 2013, employment is on track to stabilising at a very low level. In a reversal of previous years, when the private sector bore the brunt of the crisis, pressures on the labour market in the programme period are likely to come mainly from the public sector, due to the envisaged completion of the restructuring of socially-owned enterprises by mid-2014 and intentions of reducing the slack in government employment. Moreover, one-fifth of total employment is still occupied at low productivity levels in agriculture, which provides a safety net but could also be a source of future labour market pressures.

Table II.4.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	25.199	26.535	30.877	33.466	34.362
Credit growth	34,2	24,4	29,9	7,4	13,3
Deposit growth	8,8	23,6	14,4	9,2	10,4
Loan to deposit ratio	1,2	1,3	1,4	1,5	1,5
Financial soundness indicators					
- non-performing loans	11,3	15,7	16,9	19,0	18,6
- total provisions to gross NPLs	187,8	168,1	149,4	129,2	126,5
- net capital to risk weighted assets	21,9	21,4	19,9	19,1	19,9
- liquid to total assets	43,3	41,5	35,1	37,7	34,5
- return on equity	10,5	4,5	5,3	6,3	4,7
- forex loans to total loans*	70,5	75,3	69,5	70,8	72,0

*Sources: National Central Bank, Ecowin/Reuters. * includes both denominated and indexed positions.*

Financial stability remains under pressure. Banks, which are dominating the financial landscape, have been through a turbulent period of increasing non-performing loans (NPLs) and falling liquidity and profitability indicators. Some banks, predominantly state-owned, had to be recapitalised (at the cost of 0.5% of GDP in 2012) or even closed down. Nevertheless, the system as a whole is still liquid and well capitalised, with regulatory capital adequacy ratio of around 20%. Lending growth has been subdued since 2011 and banks have struggled with the fall-out from the crisis, in particular in the corporate sector (corporate NPLs stood at 18.6% at end-2012). The share of investment lending to the corporate sector has been creeping up in the last few years, but remains low, below 18%.

Evaluating risks in the economy is likely to remain difficult, hindering financial intermediation. Economic uncertainty, albeit slowly declining, along with demand and supply side constraints, will probably continue impeding a robust revival in lending. The central bank has recently tried to reduce some of the obstacles to new lending by relaxing its rules on NPLs treatment and giving banks greater freedom in determining their borrower's creditworthiness, the effectiveness of which is still to be tested.

4.2. PUBLIC FINANCE

Since 2008, the budget deficit has steadily increased and systematically overshot targets to reach an estimated 6.4% of GDP in 2012. The deficit was even higher if quasi-fiscal deficits, such as those related to bank recapitalisations, are taken into account. Total revenue and expenditure ratios increased by 0.9 and 2.4 percentage points over the previous year, to 41.5% and 47.9% of GDP by the end of 2012. Revenues were boosted by stronger receipts from income taxation, as real wages have increased through most of the year and corporate profits had swelled in 2011. In an election year, expenditures exploded across almost all major categories, reaching their highest level in years. Most importantly, previous small gains in expenditure consolidation, in particular in compensation of employees, subsidies and pensions, have been wiped out.

The new government took urgent measures to stem further rise in the deficit. A major increase in indirect taxation in October 2012, including a VAT rate hike from 18% to 20%, provided the bulk of the correction. Lower indexation of pensions and public sector wages in the autumn, a cap on the

highest salaries and better control of own-source revenue of government bodies contributed to savings on the expenditure side. However, additional spending on agricultural subsidies, social protection and subsidised loans undid the savings on the expenditure side. A number of other measures, encompassing increases in excises on cigarettes and petroleum products, higher personal income tax on dividends and interest income as well as higher corporate income tax (both rates were increased from 10% to 15%), conditional amnesty on tax interest arrears, changes in the VAT registration threshold and procedures, differentiated excise duties on gas oil and liquefied petroleum gas, and the abolishment of 138 fees and charges have been introduced as well. Some of these measures took effect only in 2013, when most of their impact is expected.

Table II.4.3:

Composition of the budgetary adjustment (% of GDP)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenues	41,0	43,6	44,1	44,1	43,7	0,0
- Taxes and social security contributions	35,6	38,2	38,9	39,3	39,1	0,9
- Other (residual)	5,4	5,4	5,1	4,8	4,5	-0,9
Expenditure	46,0	49,8	47,7	46,0	44,7	-5,1
- Primary expenditure	44,6	47,7	45,1	43,4	42,4	-5,2
of which:						
Gross fixed capital formation	3,6	3,6	3,6	3,5	3,7	0,1
Consumption	18,5	20,1	19,1	18,7	18,3	-1,9
Transfers & subsidies	22,5	24,0	22,4	21,2	20,5	-3,5
Other (residual)	0,0	0,0	0,0	0,0	0,0	0,0
- Interest payments	1,4	2,1	2,6	2,6	2,3	0,1
Budget balance	-5,0	-6,1	-3,6	-1,9	-1,0	5,1
- Cyclically adjusted	-4,9	-5,3	-2,9	-1,6	-1,1	4,2
Primary balance	-3,6	-4,0	-1,0	0,7	1,3	5,3
Gross debt level	50,3	65,1	65,2	58,7	58,4	-6,7

Sources: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations.

The main goal of the fiscal strategy is to reduce government debt. To this end, an ambitious, frontloaded, and expenditure based fiscal adjustment is targeted over the programme horizon. In accordance with fiscal rules, the strategy aims at a medium-term deficit of 1% of GDP. After increasing in 2013, total revenue as a ratio to GDP are expected to level off before declining slightly in the last year of the programme horizon. Strong reductions in the expenditure ratio are envisaged, by 5.1 percentage points over the period, triggered by cuts in current expenditure. However, although consolidation efforts may be sufficient to lead to a significant deficit reduction in 2013, they are likely to fall short in bringing the desired consolidation path. In view of the more optimistic macroeconomic scenario, divergences from the planned deficit targets could be more prominent in the outer years of the programme.

Box II.4.1: The budget for 2013

The parliament adopted the 2013 state budget on 1 December 2012.

The main consolidation measures are on the revenue side and most of them have already been in force since October 2012. On the expenditure side, the main adjustment is to come from lower indexation of pensions and public sector wages.

Main measures in the budget for 2013

Revenue measures*	**Expenditure measures****
Personal income tax (increasing the rate on interest income, dividends and profit share form 10% to 15%) **(0.2% of GDP)**	Savings from limited indexation of pensions and salaries (2% in April) **(-0.7% of GDP)**
Corporate income tax (rate increased from 10% to 15%) **(0.6% of GDP)**	Savings from centralising own-source revenue **(-0.5% of GDP)**
Value added tax (increased general rate from 18% to 20%) **(0.9% of GDP)**	
Excise duties on cigarettes **(0.2% of GDP)**	
Excise duties on petroleum products **(0.1% of GDP)**	
VAT revenue from higher excise duties **(0.05% of GDP)**	
Conditional tax amnesty (minimum effect) **(0.1% of GDP)**	
Total tax revenues effect (2.1% of GDP)	**Total expenditure effect (-1.3% of GDP)**

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: Pre-Accession Economic Programme (PEP) 2013

The 2013 budget sets an ambitious but overly optimistic deficit target of 3.6% of GDP. A package of tax measures and reforms (see table) is expected to boost the revenue side of the budget by 2.1% of GDP, expenditure cuts to contribute 1.3% of GDP, and one-off non-tax revenue – another 0.3% of GDP. The revenue forecast has taken into account increased taxation but also the expected contraction in private consumption, weak labour market and obligations under existing trade agreements. The expenditure side of the budget may become under strain, though, as some of the planned structural reforms (for example, completing the restructuring of socially-owned enterprises), new investment projects, and the bleak unemployment situation are likely to be sources of additional expenditure pressure. Following a 2% indexation in April, uncertainties are also stemming from moving to pension and public sector wage indexation in line with inflation.

Achieving deficit targets in 2014-2015 will require significant additional measures. After 2013, the envisaged adjustment is foreseen to be entirely expenditure based. Some savings in subsidies

could be expected in case the government follows on its commitment to finalise the restructuring of socially-owned enterprises. However, the process of reducing spending on wages and pensions, from their still very high levels, is likely to decelerate significantly after moving to inflation indexation. Other reform initiatives, in education, health care, public finance management, pensions and social security, with potentially important budgetary impact, are still in their preparatory phase and, even if implemented, may not lead to efficiency gains and lower expenditure in the short term. Sustained efforts would be needed to put public finances on a sounder footing and there is a need to design and implement a credible medium-term consolidation strategy with a focus on further reducing current expenditure.

Heightened uncertainty calls for developing alternative scenarios. In view of the high deficit and rising government debt, the envisaged medium-term fiscal stance is ambitious and appropriate. However, the risks to this profile are numerous. Fiscal performance is vulnerable to lower rates of economic activity and revenue collection (already visible in early 2013 when revenue underperformed), and interest payments could turn out higher than expected, as has been correctly pointed out in the programme. Another risk factor, also mentioned in the programme, is inflation (and inflation volatility), which tends to increase expenditures more than revenues. Inflation-indexed expenditure constitutes more than half of all consolidated budget spending, crowding out more productive expenditure and pointing to a major deficiency of the budget structure. Important risks to the fiscal position, which remain largely ignored in the programme, stem from possible delays or lack of structural reforms in key sectors. The high vulnerability of the budget calls for developing alternative macroeconomic and fiscal scenarios, which the programme fails to provide.

Fiscal rules proved weak and insufficient to guard fiscal performance. Government and government-guaranteed debt exceeded the 45% of GDP limit in 2011, reaching more than 60% in 2012. Major weaknesses of the rules are the lack of envisaged sanctions in case they are not implemented and the asymmetry imbedded in them – not being very demanding in the correction phase. According to the government fiscal strategy, and in a rather optimistic scenario, it will take until 2020, i.e. almost a decade after it had passed the limit, until the debt falls again below the 45% threshold. In addition, inflation indexation of wages and pensions brings uncertainty in budgetary planning and slows down the adjustment in current expenditure.

Box II.4.2: Debt dynamics

Government debt is envisaged to stabilise in 2013 before being reduced significantly in 2014. Nominal GDP growth is the main factor expected to pull the debt ratio down, while interest expenditure are seen contributing 7.5 percentage points to its increase over the period 2013-15. Stock-flow adjustment is also adding to the debt, most likely due to nominal dinar depreciation and new state guarantees, with the exception of 2014 when significant privatisation proceeds are expected.

Table II.4.4:

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

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**50,3**	**65,1**	**65,2**	**58,7**	**58,4**
Change in the ratio	4,8	14,8	0,1	-6,5	-0,3
Contributions [2]:					
1. Primary balance	**3,6**	**4,0**	**1,0**	**-0,7**	**-1,3**
2. "Snow-ball" effect	**-2,7**	**0,7**	**-4,6**	**-2,2**	**-2,2**
Of which:					
Interest expenditure	1,4	2,1	2,6	2,6	2,3
Growth effect	-0,6	1,0	-1,1	-2,1	-2,1
Inflation effect	-3,5	-2,5	-6,0	-2,7	-2,3
3. Stock-flow	**3,9**	**10,1**	**3,7**	**-3,6**	**3,2**

Notes:

[1] End of period. In accordance with the Budget System Law, includes all government-guaranteed debt and non-guaranteed local government debt. Differs from government debt according to the national methodology (Public Debt Law), which does not include non-guaranteed local government debt.

[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 between cash and accrual data.

Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations.

Recent consolidation measures have halted the exponential increase in debt but sustainability remains an issue. Government plans to turn the tide of rising debt as of 2014 rely on an optimistic macro-fiscal framework and are subject to specific risks related to expected privatisation proceeds. Debt remains very sensitive to exchange rate dynamics and, although the dinar-denominated market for government securities has expanded steadily over the recent years to reach almost a fifth of all debt, foreign currency denominated debt will continue dominating and be a major source of risk. Quasi-fiscal deficits, mainly to support inefficient public sector enterprises either directly through issuing new debt, or indirectly – through providing state guarantees, have also added to government debt. Highlighting the gravity of the problem, government-guaranteed debt, more than half of which has already been activated, stood at close to 9% of GDP in end-2012. Therefore, better public enterprises management and lowering state exposure to assuming new obligations, going beyond the suggested annual limit of 1% of GDP in new guarantees, should be key elements of future efforts to reduce government debt.

4.3. STRUCTURAL REFORMS

Future growth prospects depend crucially on developing a viable private sector. Since 2008, the economic crisis has hit disproportionately the private sector, while the public sector has remained largely protected. By 2012, the number of private entrepreneurs shrank by more than 30% since its peak four years ago. At the same time, employment in the public sector increased and government expenditure reached its highest level in almost a decade. Public deficits rose to a point threatening macroeconomic stability, exposing the limits of the current economic model.

Rethinking the role of the state in the economy and providing and implementing better regulations to improve the functioning of the markets should be a priority. The state continues to control about 20% of the prices in the consumer basket, provides far-reaching and distortive aid (five times the EU average) and has stakes in about 1300 enterprises making annual losses of 3.5% of GDP.([5]) Administrative and regulatory barriers at national and local level are also high, imposing undue costs to businesses. Labour market rigidities, infrastructure deficiencies and lack of competition in key sectors undermine the economy's potential.

The authorities are well aware of the scale of the issues and have a wide-ranging reform agenda. Declared policy intentions are ambitious and address major obstacles to growth. However, most of the proposed measures are still in their preparatory phase (ending June 2013) and lack sufficient details in order to be fully evaluated. Their prompt implementation is of utmost importance and will be a real test for the authorities. The implementation period is envisaged from July 2013 until 2015, without clear sequencing and prioritisation. The need of sweeping reforms in many sectors will pose a challenge to government commitments, as they would have to be constantly balanced against their potential social and economic costs and implications. In order to bring credibility to the reform agenda, there is a need to operationalize the various reform intentions and design clear action plans for their timely implementation.

An important element of the programme is the plan to accelerate reforms of state enterprises and complete restructuring of socially-owned enterprises by mid-2014. Socially-owned enterprises undergoing restructuring are a major drain on the budget, receiving direct and indirect subsidies, and on the economy, by accumulating arrears towards their employees, counterparts and the state. The government is planning to privatise (fully or partially) the viable ones or sell the assets and initiate bankruptcy procedures for those that have no market prospects, using the accumulated funds to finance social programmes for their employees. The bulk of the restructuring is to be finalised already in 2013 and it is a welcome step improving allocation of resources. However, short-term costs for

([5]) Proposed Fiscal Consolidation Measures for 2012-2016, Fiscal Council of the Republic of Serbia, p.95

social programmes and severance payments may have been underestimated, as there are around 52 thousand people employed in these enterprises who may potentially benefit from them. Further efficiency gains are expected in state-owned enterprises from introducing a performance evaluation system, corporatisation (transforming all large state enterprises into joint stock companies), liberalisation of activities, and privatisation of large state enterprises. These plans are less specific, though, and should be followed with determination in order to achieve the desired results. Furthermore, privatisation could have been given higher priority, as a way to bring in new capital and technologies and reduce opportunities for rent seeking.

Further gains could be made through improving the business environment. The government has already abolished more than 100 fees and charges and is continuing the implementation of the so called "regulatory guillotine' project to reduce administrative barriers. A number of other measures, simplifying administrative procedures or improving financial discipline and facilitating market exit, have been implemented or are in the pipeline as well. Legislative changes are also expected to simplify and shorten the process of obtaining building permits and accelerate land expropriation procedures which have been an obstacle in the implementation of infrastructure projects.

There is scope for increasing competition. Strengthening the capacity of the Commission for Protection of Competition and reducing state subsidies are seen as a way to address competition problems. However, recent government measures and announcements to provide state aid to various sectors (automotive, steel, hydropower and IT) go against the declared objective. Efforts to strengthen competition should be complemented by additional measures, like a stepwise price liberalisation to reduce price distortions and thoroughly reviewing all forms of state aid (subsidies, tax incentives, soft loans and guarantees) and shifting to horizontal, less distortive forms of aid. In view of the present significant market distortions, price controls and subsidies, government plans to pursue an industrial policy fostering investments in some particular industries viewed as potential export sectors may be counterproductive as asymmetric information does not allow for an accurate evaluation of competitive advantages.

A dismal labour market calls for urgent and decisive measures supporting sustainable employment creation and improving social protection. Plans to amend labour and employment regulations in 2013 to provide higher flexibility and mobility on the market are steps in the right direction. Improving the accessibility of the social security system, introducing means-tested benefits, and increasing support and protection of the poorest strata of the society by devising social maps in 2013 are also welcome, as they would channel the scarce budget resources to those who are most in need. Implementing the Strategy for Education Development until 2020, with its particular focus on aligning the curricula to the market requirements and increasing the coverage and quality of the education system, could also alleviate some of the labour market problems over the medium- to long-term. However, while the envisaged streamlining of the school network, number of classes and teaching staff to the rate of student enrolment may create budgetary savings, it should be carefully designed so as not to undermine other government priorities in education and in pursuing balanced regional development.

Labour taxation remains high and is a serious impediment to reducing unemployment and unofficial labour. The tax wedge on labour amounts to 64% of the average net wage([6]) and is an important factor for the low employment and activity rates. The programme does not explicitly assume any reduction in labour taxation over the programme period, which could have contributed to labour market recovery; In addition, active labour market programmes remain underfunded([7]) and miss opportunities to seriously address youth and long-term unemployment.

([6]) Proposed Fiscal Consolidation Measures for 2012-2016, Fiscal Council of the Republic of Serbia, p.161
([7]) Country Economic Memorandum. The Road to prosperity: Productivity an Exports, Volume 1, The World Bank, p.47

Wide-ranging public finance management reforms are needed to support fiscal consolidation efforts and the business environment. Since September 2012, a number of measures to improve public finance management have been undertaken – abolishment of 138 para-fiscal charges, three-year capital budgeting, cap on the highest salary in the public sector, better control over own-source revenue, and expansion of the Single Treasury Account coverage. Public finance reforms are expected to continue in 2013, including the introduction of a uniform system of pay grades, setting up of integrated central registry of government employees, preparing a programme of government employment rationalisation, adopting a medium-term strategy and an action plan for public administration reform, simplifying tax procedures and modernising the tax administration, linking property tax base with the market value of properties and introducing mandatory wage ceilings in large state enterprises.

Aging population and budget pressures demand further reforms of the pension and health care systems. Important structural deficits have accumulated in the pension and health care sectors. To tackle the high and unsustainable deficits in the pension system, the programme announces the introduction of penalties for early retirement (already in 2013), a tightening of the conditions for acquiring pension rights based on extra service credit, and a change of some of the parameters related to retirement requirements and the status of specific groups. However, these measures have not been specified and their fiscal impact was not assessed. A major change is envisaged in health care financing, where the system would move from a cost-based to performance-based funding. Reduction in non-medical staff and hospital beds, and introducing centralised procurement of medicines are also expected to contribute to increased efficiency of the sector, lowering government health care spending by 0.3 percentage points of GDP over the programme horizon.

Annex: Overall Assessment of Programme Requirements

The government adopted the programme on 24 January and submitted it to the European Commission on 31 January. The programme is in line with the medium-term fiscal strategy and the 2013 budget and covers the period 2011-2015. In line with the requirements to progressively adapt the Pre-Accession Economic Programmes to the EU strengthened economic governance, the programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth. However, the analysis of competitiveness issues could be deepened further and a clear timeline, prioritisation and sequencing of structural reform measures could be developed.

Macro framework

The programme presents a clear and concise picture of past developments and covers all relevant data at the time of submission. The macroeconomic framework, albeit optimistic in the outer years, is sufficiently comprehensive and coherent. Links between the macroeconomic scenario and the structural reform measures could have been made more explicit. In light of the many risks and the heightened uncertainty, the authorities could have considered complementing the macroeconomic projections with alternative scenarios.

Fiscal framework

The fiscal framework is based on the presented medium-term macroeconomic scenario and is coherent, consistent, sufficiently comprehensive and integrated with the overall policy objectives. Revenue and expenditure measures are detailed and well explained for 2013, and less so, for the remaining years of the programme. The fiscal scenario is very ambitious, but rather optimistic due to the macroeconomic assumptions, especially in 2014-2015. The programme does not present long-term projections of population trends and the implications of aging population on public finances, in particular on the health and pension systems. In December 2012, Serbia has notified for the first time its government deficits and debt levels, although fiscal data are still not in full compliance with ESA'95 standards.

Structural reforms

The structural reform framework is comprehensive. However, the programme would have benefitted from providing more details and a clear timeline and sequencing of the planned measures, along with estimates of their budgetary impact.

5. TURKEY

Executive Summary

Following a substantial slowdown in 2012, economic growth is projected to gradually pick-up over 2013-2015. After two years of record growth, a policy tightening cycle was appropriately launched in late-2011 to cool the mounting overheating pressures. Growth slowed to 2.2% in 2012 from 8.8% in 2011, in part reflecting the impact of this tighter policy - geared towards a soft landing - in combination with some external factors, in particular sluggish demand in the EU markets and the repercussions of the war in Syria. Since late 2012, domestic demand has been recovering on the back of improving confidence and buoyant labour market conditions, including significant wage increases, providing some ground for the authorities' domestic demand driven growth scenario over the medium term.

Monetary policy and macro-prudential measures have been instrumental in curbing credit growth and, to a lesser extent, inflationary pressures, but risks may re-emerge. The pace of credit growth fell significantly from the peak in the third quarter of 2011 to around 20% at the end of 2012. Inflation declined to 6.2% year-on-year in December 2012, down from 9.5% in mid-2012, in the context of easing domestic demand, slowing food prices and a relatively stable exchange rate. However, this was still above the central bank's target (although within its tolerance band) and inflation expectations remain elevated. Recent increases in credit growth and the prospects of higher GDP growth, solely driven by domestic demand, may cast doubts on the likeliness of the disinflationary path foreseen by the authorities in the short and medium term.

The expected strengthening of domestic demand calls for a policy mix geared towards current account sustainability in a context of benign inflation. Structural policies can be helpful in supporting such objectives. There is scope in Turkey for a further strengthening of competition through continuing liberalization of product and service markets, especially in non-traded services, that could also facilitate the monetary stance. Beyond the new incentive system adopted in 2012 and the implementation of the new Commercial Code as of 2013, structural reforms to strengthen the investment climate would not only be conducive to higher private investment, competitiveness and growth but also attract foreign savings in the form of foreign direct investment, thus ensuring a more sustainable financing of the current account. Crucial in this context will be an up-grading and better use of human capital through the pursuit of the education agenda and the deepening and widening of labour market reforms.

Turkey's large external financing needs continue to pose a threat to macro-financial stability, in spite of the recent reduction in imbalances. The current account deficit has adjusted at a significant pace, and fell from 9.7% of GDP in 2011 to 5.9% of GDP in 2012. In tandem, the quality of the financing has somewhat improved, albeit risks remain substantial as debt-creating flows and short-term borrowing still represented over half of the total inflows in the first nine months of 2012. While attracting more FDI can limit volatility, the excessive reliance on foreign financing can be reduced by promoting domestic savings. While further financial sector reforms might be worth considering to provide incentives and mitigate risks to private savings, the recent reform of private pensions and the fiscal discipline envisaged over the medium term are steps in the right direction.

After some relaxation in 2012, the authorities envisage a fiscal tightening in 2013-2015, somewhat back-loaded and exclusively expenditure-led over 2014-2015. The general government deficit would decline to 0.9% of GDP in 2015 while a primary surplus of around 2% would be achieved over the period. While the path of such fiscal strategy might be reassessed in the light of actual budgetary developments in 2012, a sufficiently tight fiscal stance is to be preserved. Not only can it contribute to

the mobilisation of domestic savings but it can also allow for a more balanced policy mix and help avoid high short-term real interest rates to achieve inflation targets, which would risk further appreciating the currency, damaging the external balance, and increasing the cost of borrowing in domestic markets.

5.1. ECONOMIC OUTLOOK AND RISKS

The programme projects a rather optimistic combination of domestic demand- driven higher growth and reduction in macro-economic imbalances. The macro framework presented in the PEP is derived from the MTP adopted in the autumn 2012 and has not been updated in the light of recent developments. It projects GDP growth to accelerate from an estimated 3.2% in 2012 to 4% in 2013 and 5% in both 2014 and 2015. As the growth rate in 2012 turned out to be significantly lower at 2.2%, the PEP's growth projections imply a significantly stronger recovery. Domestic-demand, picking up in 2013 and then further strengthening, would be the sole driver of growth. In contrast to 2012, the contribution of net exports to growth would be nil or slightly negative. The rebalancing to domestic demand, mainly private consumption and investment, is plausible and can to some extent alleviate the impact on growth of the current international uncertainty. More dubious are its repercussions on macro-economic imbalances. It would not lead to inflationary pressures. According to the PEP, CPI inflation would fall from 9.1% in 2012 to 7% in 2013 and 5% in 2014-2015. Similarly, it would not entail increased demand for goods and services as the current account deficit is expected to be gradually reduced from an estimate of 7.3% in 2012 to 6.5% by 2015. The Commission's winter forecasts are less sanguine. The narrowing of external imbalances in 2013-2014 is primarily due to lower domestic demand and GDP growth compared to the PEP's scenario while the disinflationary path is slower.

Table II.5.1:

Comparison of macroeconomic developments and forecasts

	2011		2012		2013		2014		2015	
	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**	COM	**PEP**
Real GDP (% change)	8,5	**8,5**	2,5	**3,2**	3,0	**4,0**	3,8	**5,0**	n.a.	**5,0**
Contributions:										
- Final domestic demand	9,7	**10,2**	0,9	**0,6**	2,6	**4,1**	4,4	**5,0**	n.a.	**4,9**
- Change in inventories	-0,3	**-0,3**	-0,1	**-0,8**	0,0	**-0,1**	0,0	**0,1**	n.a.	**0,2**
- External balance of goods and services	-1,4	**-1,5**	0,8	**3,3**	0,2	**0,0**	-0,7	**-0,1**	n.a.	**-0,2**
Employment (% change)	6,6	**6,7**	2,1	**2,6**	1,2	**2,0**	1,9	**2,0**	n.a.	**2,0**
Unemployment rate (%)	10,2	**9,8**	8,2	**9,0**	7,6	**8,9**	7,0	**8,8**	n.a.	**8,7**
GDP deflator (% change)	8,9	**8,8**	8,3	**7,8**	7,3	**5,8**	5,4	**6,0**	n.a.	**6,3**
CPI inflation (%)	9,0	**6,5**	8,0	**9,2**	7,7	**7,0**	5,6	**4,9**	n.a.	**5,0**
Current account balance (% of GDP)	-9,9	**-10,0**	-5,9	**-7,3**	-6,6	**-7,1**	-7,5	**-6,9**	n.a.	**-6,5**

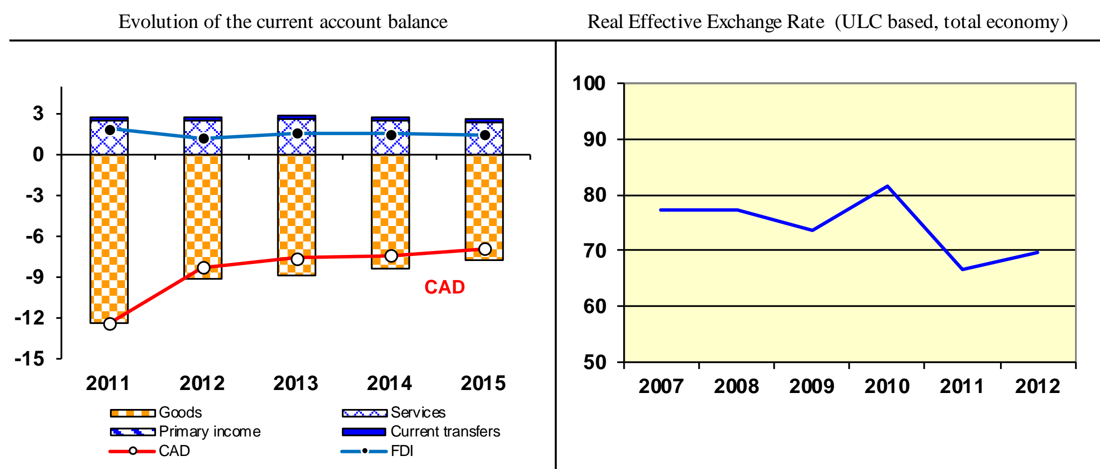
Sources: Pre-Accession Economic Programme (PEP) 2013, Commission Winter 2013 forecast (COM)

A rebalancing to domestic demand entails risks for the reduction of macro-economic imbalances. It adds pressures to still elevated inflation rate and inflation expectations in a context of further easing of the monetary policy in December 2012 -when the one-week repo rate has been cut for the first time in 16 months- which seems to have already translated into higher credit growth. A stronger than foreseen appreciation of the real exchange rate would further dampen exports' competitiveness since key cost-cutting and productivity-enhancing economic reforms have tended to be slow. It could combine with obstacles to a further geographical diversification towards eastern and

southern neighbours –temporarily boosted in 2012 by gold exports to Iran- which was initiated to alleviate the effects of sluggish external demand from traditional trade partners. Although these markets offer high potential, on-going political and military conflicts and tensions may put at risk their economic stability and their trade. Subdued export growth in combination with stronger imports entailed by a surge in domestic demand could lead to a renewed deterioration of external imbalances and contribute to dampen growth.

Turkey remains vulnerable to a slowdown of capital inflows, particularly due to its high reliance on short-term external corporate financing. Corporate sector debt rose to around 50% of GDP in 2012 and the net short FX position of the sector has increased significantly, albeit from very low levels. If current rates of corporate credit growth in FX were to persist, the sector could face important currency risks with knock on implications for credit risk for banks. External (corporate) debt dynamics thus require close monitoring as does the current account deficit. Overall, foreign funding needs remain large and short-term capital inflows continue to play a significant role. While expecting some more supportive financing conditions from Turkey's upgrade to investment grade by Fitch in November 2012, the authorities foresee some rebalancing in the composition of the current account external financing and in the relative shares of foreign and domestic finance. Inflows of FDI are expected to accelerate, partly thanks to the higher transparency and investors 'protection brought about by the implementation of the new Commercial Code and the new investment incentive system , while the share of more volatile portfolio investments would decline. The implementation of the privatisation agenda and of further reforms to boost competition and the business environment would be helpful to attract higher FDI inflows. Steps are also being taken to reduce dependence on external financing and raise national savings, both public and private, as evidenced by the recent reform of private pensions and the envisaged tightening of fiscal discipline. Overall, Turkey's structural strengths, notably its resilient banking sector and favourable public debt dynamics - general government debt fell to 36.3% in 2012- somewhat mitigate risks to the economy.

Graph II.5.1 : **External competitiveness and Current account**



Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN services

The resilience of the banking sector contributes to macro-financial stability. Credit growth has been very rapid over recent years. It has moderated from around 30% in 2011 to about 20% at the end of 2012 (FX adjusted; 16% unadjusted), about 5% above the central bank target, alleviating overheating risks while buffers in the banking system limit stability ones. A significant portion of credit growth is likely to reflect financial deepening as new borrowers gained access to finance thanks to the post 2001 very strong catching-up in per capita income. Legal reforms have substantially

Table II.5.2:
Financial sector indicators

	2008	2009	2010	2011	2012
Total assets of the banking system, mEUR	58.454	50.808	58.618	61.351	72.452
Foreign ownership of banking system	25,6	24,0	24,3	26,0	24,3
Credit growth	22,4	4,4	33,5	23,8	17,4
Bank loans to the private sector ratio	1,0	1,0	1,0	1,0	1,0
Deposit growth	21,8	18,0	18,0	19,2	11,3
Loan to deposit ratio	0,6	0,6	0,6	0,8	0,9
Financial soundness indicators					
- non-performing loans	4,2	6,5	5,8	3,6	3,2
- net capital to risk weighted assets					
- liquid to total assets	28,5	32,0	29,0	20,0	18.0 Q3
- return on equity	17,0	20,0	13,6	12,5	14.9 Q3
- forex loans to total loans %		31,9	31,9	33,8	31.1 Q3

Sources: National Central Bank, Ecowin/Reuters

strengthened financial intermediation. A series of safeguard measures protect households, whose liabilities have grown, albeit from a low base, from currency and interest rate risks. A new macro-prudential framework adopted in late 2011 and the establishment of a Financial Stability Committee aim at further monitoring and mitigating systemic risks. Financial indicators, including capital adequacy ratios (on average 17.9% in 2012) and the level of non-performing loans (less than 3% in December 2012), demonstrate the presence of large buffers in the system. Moreover, the overall level and degree of sophistication of financial development remains low by international standards, a factor that helped Turkey in weathering the recent financial turmoil. At the same time, interest rate increases and maturity mismatches are a source of bank vulnerability, especially given Turkish banks' large portfolios of fixed coupon and discount government bonds.

5.2. PUBLIC FINANCE

In contrast to previous years, the deficit target is likely to be missed in 2012. Targets have been largely met in 2010 and 2011 as the robust growth performance resulted in an increase in fiscal revenues. However, in 2012, with growth slowing markedly, the central government budget deficit is estimated to have reached around 2.0% of GDP compared to an original budget target of 1.5% and an outturn of 1% in 2011. This is primarily due to a rise in personnel expenditures -an increase in both the number of permanent staff and wage indexation- and in transfers to state owned enterprises as a result of delayed price adjustments in the energy sector. The fast rise of current spending contributes to budget rigidity while its compensation through increases in indirect taxes raises questions on the adequacy of the policy mix. In spite of rises in the amounts and rates of excises and SCT in September 2012, indirect tax revenues, notably VAT and SCT, only increased to a limited extent as a result of the slowdown in private consumption and imports. At the same time, the general government debt remained at a relatively comforting level and its ratio fell further to about 36% of GDP by early 2013 from 39% in 2011. In view of this moderate ratio, fiscal sustainability is not jeopardised at current levels of budget deficits and structural balances.

Table II.5.3 :

Composition of the budgetary adjustment (% of GDP)

	2011	2012	2013	2014	2015	Change: 2012-15
Revenues	36,4	37,0	37,9	37,2	36,6	-0,4
- Taxes and social security contributions	9,2	9,4	9,7	9,6	9,5	0,1
- Other (residual)	27,2	27,6	28,2	27,6	27,1	-0,5
Expenditure	36,8	38,6	39,4	38,4	37,5	-1,1
- Primary expenditure	33,4	35,1	35,9	35,2	34,4	-0,7
of which:						
Gross fixed capital formation	3,3	3,5	3,4	3,5	3,5	0,0
Consumption	16,6	17,5	17,7	17,3	16,8	-0,7
Transfers & subsidies	0,8	0,8	0,7	0,7	0,6	-0,2
Other (residual)	12,7	13,3	14,1	13,7	13,5	0,2
- Interest payments	3,4	3,5	3,5	3,2	3,1	-0,4
Budget balance	-0,4	-1,6	-1,5	-1,2	-0,9	0,7
- Cyclically adjusted	0,0	-0,1	-0,1	-0,1	0,0	0,1
Primary balance	3,0	1,9	2,0	2,0	2,2	0,3
Gross debt level	39,2	36,5	35,0	33,0	31,0	-5,5

Sources: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations

Fiscal discipline is to be somewhat tightened in 2013, paving the way for additional expenditure-led consolidation over 2014-2015. According to the programme, the general government deficit would fall from 1.6% of GDP in 2012 to 1.5% in 2013 and 0.9% of GDP in 2015. The primary surplus would increase by 0.1% of GDP in 2013 and be maintained at about 2.0% of GDP throughout the 2013-2015 period. This targeted primary surplus path is lower than that specified in last year's PEP. This is largely due to the 0.8 percentage point of GDP deterioration in the central government's surplus in 2012 (from 1.0% to 0.2% of GDP), due to spending overruns. Continued pressures on current spending translate into higher expenditures (by 1.3 percentage point of GDP) in the medium term relative to the previous MTP, despite assumptions of a compression in personnel spending from 2014 onwards. The general government debt stock is projected to decrease to 31% of GDP at the end of 2015, chiefly due to better financing conditions. The 2013 budget foresees an increase in the ratio of total expenditures to GDP from 38.6% in 2012 to 39.4%, mainly driven by current expenditures and transfers, including public wages and pensions. Wages will increase by 3% in each of the two semesters of 2013 and pensions by 5.32 and 2.34% respectively in January and July. Increases are also projected for local government and social security expenditures. Total revenues are also expected to increase and reach 37.9% of GDP, mostly on account of increased privatisation receipts which, together with sale of degraded forest land, would rather optimistically increase from 0.1% in 2012 to 0.6% and indirect taxes boosted by higher growth and by the full effect of the 2012 increases in excises and SCT. An evenly sequenced, expenditure-led, further consolidation is projected over 2014-2015. Total expenditures would decline to 37.5% of GDP in 2015, primarily due to reductions in consumption and transfers, while the ratios of revenues to GDP would follow a declining trend and reach 36.6% in 2015.

Box II.5.1 : Debt dynamics

Table II.5.4 :

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

	2011	2012	2013	2014	2015
Gross debt ratio [1]	**39,2**	**36,5**	**35,0**	**33,0**	**31,0**
Change in the ratio	-3,2	-2,7	-1,5	-2,0	-2,0
Contributions [2]:					
1. Primary balance	-0,2	-0,1	-0,1	-0,1	-0,1
2. "Snow-ball" effect	-6,0	-3,4	-2,9	-3,1	-3,1
Of which:					
Interest expenditure	0,3	0,2	0,2	0,2	0,2
Growth effect	-3,1	-1,1	-1,3	-1,6	-1,5
Inflation effect	-3,2	-2,5	-1,8	-1,7	-1,7
3. Stock-flow	**3,0**	**0,8**	**1,5**	**1,3**	**1,2**

Notes:

[1] End of period.

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

Source: Pre-Accession Economic Programme (PEP) 2013, ECFIN calculations

The moderate general government debt ratio to GDP is projected to fall from 36.5% at the end of 2012 to 31% in 2015. The main contribution to the reduction comes from primary surpluses which are set to remain at around 2% of GDP over the medium-term. The so-called "snowball effect" (more precisely from the inflation and growth effects) has a minor debt reducing effect. Stock-flow adjustments are not seen to impact the debt to GDP ratio significantly.

The envisaged fiscal stance is broadly appropriate but the composition of spending leaves room for improvement. Primary spending increased rapidly in previous years, from 29.2% of GDP in 2008 to 35.1% in 2012 and its growth ought to be restrained. Even though the reduction foreseen in the programme is moderate, reversing the increasing rigidity of current spending - a structural weakness of the Turkish budget- could prove to be a challenging task. In particular, the public sector wage bill and pensions, which have recently grown above the economy's potential, may be difficult to constrain in the absence of any further structural reform. On the other hand, given Turkey's demographic and economic development situation, additional spending needs remain very large in areas such as education and infrastructure, and room has to be created for such spending, possibly through additional savings. The intended shift to performance-based budgeting announced by the authorities in 2012 could help identify and exploit more saving opportunities.

The implementation of the fiscal stance faces downside risks mainly related to the growth assumptions and the political cycle. The growth scenario, in particular for 2013, is above consensus, and more optimistic than the Commission's forecast. A stronger cyclical downturn would likely worsen the fiscal balance. In addition to lower growth effects, the revenue base is likely to decrease especially for indirect taxes, as a result of the forecasted disinflation process. Altogether, a stronger decline in fiscal revenues than projected in the PEP could materialise. In addition, the authorities may be confronted with a continuation of the spending pressures observed in 2012, the more so since local, presidential and parliamentary elections are all due in 2014-2015. The current volatility may also lead to pressures to increase short-term discretionary spending to counterbalance the negative effects on growth and employment. The resulting combined effect of markedly lower fiscal revenues and pressures for higher current spending would undermine the implementation of the envisaged fiscal path.

5.3. STRUCTURAL REFORMS

The programme's structural reform agenda represents a mere continuation of the plans put in place over the last years. Its general aim remains to increase efficiency in the private sector and the public administration and to support the strengthening of market forces. More emphasis is put on labour market reforms, to support job creation during the economic transformation process. Although Turkey has made some efforts in recent years, more could be done to improve the business and investment climate as well as to build additional capacity of skilled labour.

A key priority for improving potential growth is to shift employment to higher-quality jobs in formal activities. Employment and labour market participation rates are on the rise, even though female participation is still very low (less than 30%), but too many of the new jobs are created in the informal sector and the skills of the majority of the labour force need substantial upgrading. Both exert a drag on productivity and competitiveness. Enrolment in the education system has risen but there is ample scope to improve quality and equity. Compulsory education has been raised to twelve years in 2012 but the educational level of some 63% of the labour force is well below that of secondary education.

Recent initiatives to improve labour market conditions go in the right direction but there is scope for additional efforts. While employment gains have been impressive in recent years, the labour market continues to suffer from structural handicaps. Some specific measures have been implemented and others are being considered. The temporary measures introduced over 2008-2011 aimed at reducing the tax wedge (social security contributions) seem to have paid off by boosting formal employment, notably of youth and women. A new incentive scheme has been adopted last year for the least advanced eastern regions. The resources for active labour market policies have increased and steps taken with a view to improving their efficiency. In line with the draft National Employment Strategy, the programme identifies some key shortcomings and outlines some future priorities. A severance payment reform is notably being prepared; a draft law liberalising temporary work has been submitted to the social partners for discussion; further flexible working patterns will be considered for amendments to the labour law and the scope of activity for private employment agencies increased. Although they are steps in the right direction, such measures are likely to be insufficient to tackle two large-scale issues, namely the very low female labour participation rate and the large informality that hampers productivity and hinders savings.

An acceleration of product market reforms is needed to boost productivity. Although Turkey has a very comprehensive privatisation agenda for 2013-2015, it is not presented in the programme. There is certainly scope for alleviating a still burdensome business environment and for strengthening competition in product and services markets, that would also advance the agenda in key aspects of accession negotiations. Greater competition in the energy, telecommunication and agricultural sectors would benefit consumers and economy-wide competitiveness and help reduce the external deficit. As Turkey is a major energy importer, progress in reforms on renewable energy and energy efficiency could help reduce the current account deficit and contain dependence on external financing. The long-planned liberalisation of the electricity and natural gas sectors needs to be implemented in full. Broadband internet services need to be more open to competition. Support to agriculture ought to rest less on price support and more on direct transfers and rural development

Annex: Overall Assessment of Programme requirements

The programme was submitted on 31 January 2013, covering the period 2013-2015. It has been adopted by the government and the High Economic Council, comprising relevant public bodies and chaired by the Prime Minister. The programme is in line with government's most recent medium-term programme, and fiscal framework. Few references have been made to the accession process.

Macro framework

The recent macroeconomic performance (lower growth, falling albeit still significant imbalances) is not adequately described and some relevant information available at the time of submission has not been included. The medium-term scenario is rather optimistic, and some key challenges are not properly assessed, for example the external sustainability including the large energy dependence of the Turkish economy in a context of volatile food and oil prices and risks of a much higher current account deficit than anticipated, or the sticky inflationary pressures observed in recent years. The framework is drawn from the MTP which was elaborated in mid-2012 and published in November 2012. The lack of updating hampers the analysis and leads to some inconsistencies compared with recent developments throughout the document.

Fiscal framework

Turkey should make better efforts to improve fiscal data at general government level, on a unified accounting basis according to ESA/international standards. In the absence of consolidated general government budget reports on a regular basis, it is difficult to make an in-depth assessment of Turkey's public finances situation. The general government data provided in the PEP differ significantly from other sources, including from IMF and OECD data. Different general government accounting methodologies continue to be used across Turkish economic agencies. The financial balances and debt of a range of quasi-fiscal institutions are not yet part of a systematic monitoring and reporting system.

Furthermore, the 2013 PEP does not describe any budget execution developments in 2012, nor does it identify and explain the measures underlying the 2013-2015 fiscal strategy. These are major shortcomings which complicate and hamper any assessment of the sustainability of Turkey's fiscal situation and policy framework. The prospective fiscal costs of the expanding social security system also call for close scrutiny against alternative scenarios of growth, employment, revenue collection and pension and health spending. Future PEP would benefit from more complete data (e.g. on general government expenditure by function, long term fiscal projections). A longer term analysis of public finance sustainability could be added to the baseline fiscal programme to better understand risks to the scenario, in particular the ones stemming from the demographic and labour situation in Turkey.

Structural reforms

The programme does not identify bottlenecks to growth as requested by the Commission in the PEP outline; it would definitely benefit from a more strategic assessment, which focuses on the medium-term. It presents a wide range of reforms related to the enterprise and financial sector, labour market, agricultural sector, public administration, education, healthcare, judiciary and the environment, often backward looking and with a strong emphasis on harmonisation with EU requirements. In many areas, concrete targets and measures exist but they are not mentioned in the PEP. As in previous years, the objectives that are identified in the programme are in general supportive to the fulfilment of the Copenhagen economic criteria, as they aim at making some key parts of the Turkish economy more competitive, and the priorities appear right. However, concrete implementation measures and timetables remain vague and their fiscal impact is not always well elaborated. The programme contains fiscal estimates on the main projects implemented in all reform sectors; the link between the structural reform agenda and the implementation of the fiscal strategy has not been strengthened, compared with previous programmes.

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