



ISSN 1725-3209 (online)
ISSN 1725-3195 (print)

EUROPEAN ECONOMY

Occasional Papers 194 | May 2014

2014 Pre-Accession Economic Programmes of the former
Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey
The Commission's overview and country assessments



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KC-AH-14-194-EN-N (online)
ISBN 978-92-79-35378-9 (online)
doi:10.2765/75040 (online)

KC-AH-14-194-EN-C (print)
ISBN 978-92-79-36122-7 (print)
doi:10.2765/78112 (print)

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European Commission

Directorate-General for Economic and Financial Affairs

2014 Pre-Accession Economic Programmes of the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey

The Commission's overview and country assessments

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessment of candidate countries' 2014 Pre-accession Economic Programmes (PEPs). The annual submission and assessment of PEPs is part of the economic and fiscal surveillance procedure for countries seeking to join the EU. It aims to prepare candidate countries for participation in the EU's multilateral surveillance and economic policy coordination procedures and plays a valuable role in helping candidate countries to develop their institutional and analytical capacities. The PEPs present a medium-term policy framework, including public finance objectives and structural reform priorities.

The former Yugoslav Republic of Macedonia, Montenegro, and Serbia submitted their PEPs for the period 2014-2016 at the end of January 2014. Turkey submitted its PEP four weeks late, at the end of February. All four programmes have been made public⁽¹⁾. Following its decision to put accession negotiations on hold and to reconsider its application for EU membership, Iceland is not covered in this year's assessment, although talks on the country's medium-term macroeconomic and budgetary outlook continue with the European Commission on a bilateral basis.

The assessment was prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of Carole Garnier and Uwe Stamm. The principal authors were Barbara Stearns-Blasing (the former Yugoslav Republic of Macedonia), Antonio Sanchez Pareja (Montenegro), Plamen Kaloyanchev (Serbia), Hans Berend Feddersen (Turkey) and Andrés Tari (overview).

The programmes and this assessment were discussed at experts' level in two multilateral meetings (at the Economic and Financial Committee and its Alternates subcommittee) held in Brussels on 8 April and 24 April 2014 and at ministerial level at the ECOFIN Council on 6 May 2014. Representatives from EU Member States, candidate countries, the European Central Bank and the Commission attended these meetings.

In line with the Commission's Enlargement Strategy of October 2013, the 2014 pre-accession economic and fiscal surveillance features more targeted conclusions and policy guidance. Finance ministers from the EU and pre-accession countries discussed and adopted these in May at the Ministerial Dialogue with a view to supporting economic reforms that shall be monitored and reviewed in next year's exercise. The conclusions are available here: <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%209561%202014%20INIT>.

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⁽¹⁾ Former Yugoslav Republic of Macedonia:
http://www.finance.gov.mk/files/u9/Pre-accession_Economic_Programme_2014_-_2016_0.pdf;
Montenegro:
<http://www.mif.gov.me/en/search/135067/Montenegro-Pre-Accession-Economic-Program-2013-2016.html>;
Serbia:
<http://www.mfin.gov.rs/pages/article.php?id=10264>;
Turkey:
<http://www.mod.gov.tr/Lists/PreAccessionEconomicPrograms/Attachments/13/Pre-Accession%20Economic%20Programme%202014-2016.pdf>.

Part I

Overview of the 2014 Programmes

Overview of the 2014 Programmes

In 2013, economic recovery took hold in the candidate countries of the Western Balkans, while growth strengthened in Turkey. Following the economic slump in 2012, net exports drove the resurgence of growth across the Western Balkan countries, but domestic demand remained weak and acted as a drag in Serbia and to a lesser extent, in the former Yugoslav Republic of Macedonia. In Turkey, the substantial slowdown in 2012 also proved short-lived, as an accommodative monetary policy stance and a fiscal stimulus in the first half of the year helped revive domestic demand and growth.

With the exception of Serbia, the pre-accession countries expect growth to gain momentum between 2014 and 2016, but downside risks are present on several fronts.

Table I.1.1:

Pre-Accession Economic Programmes 2014 Key indicators

	2010	2011	2012	2013e	2014	2015	2016
Real GDP growth (% change)							
The former Yugoslav Republic of Macedonia	2.8	3.0	-0.4	3.3	3.2	3.8	4.5
Montenegro	2.5	3.2	-2.5	2.6	3.6	3.5	3.8
Serbia	1.0	1.6	-1.7	2.0	1.0	1.8	2.0
Turkey	9.2	8.8	2.2	3.6	4.0	5.0	5.0
Unemployment rate (% , LFS)							
The former Yugoslav Republic of Macedonia	32.1	31.4	31.0	29.1	28.1	27.1	26.0
Montenegro	19.7	19.7	19.7	19.5	19.2	19.0	18.8
Serbia	19.2	23.0	24.6	25.0	25.7	25.7	25.0
Turkey	11.9	9.8	9.2	9.5	9.4	9.2	8.9
Current account balance (% of GDP)							
The former Yugoslav Republic of Macedonia	-2.0	-2.5	-3.0	-3.0	-4.6	-5.7	-5.1
Montenegro	-23.0	-17.7	-18.4	-15.4	-14.7	-13.7	-12.4
Serbia	-6.9	-9.2	-10.5	-6.0	-4.5	-4.0	-3.5
Turkey	-6.2	-9.7	-6.1	-7.1	-6.4	-5.9	-5.5
Inflation (CPI, annual % change)							
The former Yugoslav Republic of Macedonia	1.6	3.9	3.3	2.8	3.3	2.7	2.5
Montenegro	0.5	3.1	4.1	2.5	2.9	2.5	2.5
Serbia	10.2	7.0	7.8	8.4	5.5	5.2	5.0
Turkey	8.6	6.5	8.9	7.5	5.4	5.2	5.0

Sources: Pre-Accession Economic Programme (PEP) 2014 for 2012-2016, CCEQ for 2010 and 2011.

The former Yugoslav Republic of Macedonia and Montenegro expect domestic demand to become increasingly important to growth because capital spending is projected to rise. Some large public and private investments pending in the tourism, energy and infrastructure sectors lend support to this

assumption, but the high import content of large projects could weaken net exports' contribution more than expected, while continuing weaknesses in the business environment could jeopardise the strong pick-up in FDI they forecast. Moreover, credit growth is likely to provide at best moderate support to investment and consumption in these countries, as it is held back by a high level of impaired loans in the banking system. The possibility that foreign-owned parent banks could further reduce their exposure to the region is another risk.

Serbia's PEP projects that growth will remain subdued over the programme, as fiscal consolidation and low net job creation are seen to undermine disposable income and thus consumption. Output growth is therefore expected to come from continued robust growth in investment and exports. Rising confidence as Serbia's accession process advances, measures to improve the business environment, and recovering demand in Serbia's main export partners, should also help.

Turkey's programme expects economic growth to strengthen further in 2014 and 2015, propelled, as in the years before, by domestic demand. However, the PEP does not take into account the impact of the turmoil that started in mid-2013 in Turkey's financial and foreign exchange markets linked to the tightening of monetary policy in the US, domestic political crises and international tensions related to the civil war in neighbouring Syria. These developments have led government bond yields to rise and the stock market and currency to fall, resulting in significantly tightened monetary policy and financial conditions. This is denting domestic demand and is likely to lead to lower growth, although net exports should provide some support as the lira's fall aids price competitiveness gains and export markets recover.

Inflation is seen on a declining path in the Western Balkan candidate countries, while in Turkey it is under upward pressure following the depreciation of the lira. Weak domestic demand, low imported inflation for food and energy as well as the strength of the euro (the unilaterally adopted legal tender in Montenegro), the national currency's peg to it (in the former Yugoslav Republic of Macedonia) and a broadly stable exchange rate (in Serbia) have dampened inflationary pressures. The inflation outlook in these countries remains benign, although some upside risks could come from the expected revival of domestic demand.

In Serbia, taming inflation volatility requires further efforts, including fiscal consolidation and stronger competition on product markets.

The near-term inflation outlook described in Turkey's PEP does not reflect the lagged effect of the lira's depreciation and is unlikely to be realised. Even the central bank's revised estimate of a 6.6 % year-end inflation in 2014 seems optimistic, while rising inflation expectations are also likely to jeopardise the attainment of the 5 % inflation target in the following two years.

Current account vulnerabilities continue to affect, to different degrees, all candidate countries. Montenegro's very high current account deficit has declined markedly over the last few years, while Serbia's began doing so in 2013. This has been supported by resurgent exports and slow or even negative import growth, the result of weak domestic demand and some import substitution. However, the current account shortfall still remains substantial in Montenegro and imports are expected to gather momentum because of stronger domestic demand. Therefore, as in all candidate countries, the potential for additional competitiveness gains should be fully exploited in order to lay the foundations for more economic diversification and further export growth, thereby limiting external vulnerabilities.

In the former Yugoslav Republic of Macedonia, the current account deficit as a share of GDP is smaller, but a likely drop in current transfers, which traditionally offset the large gap in the trade balance, might lead to its increase. The financing of the external deficit in all of these countries should primarily be ensured by focusing on attracting strong FDI inflows.

Turkey's recent market turmoil also casts doubts over its PEP's scenario for the current account, as a lower and more export-oriented growth profile is likely to improve the current account faster than the authorities expect. However, the strong reliance on relatively short-term capital flows to finance the deficit makes Turkey vulnerable to changes in risk perception and international yield differentials. Therefore, improving the investment climate is especially important, along with increasing national saving.

Table I.1.2:

Pre-Accession Economic Programmes 2014
Fiscal indicators

	2010	2011	2012	2013e	2014	2015	2016
Total revenue* (% of GDP)							
The former Yugoslav Republic of Macedonia	34.8	31.9	31.9	33.6	31.7	31.2	30.7
Montenegro	42.3	39.7	41.3	42.9	40.6	39.1	38.1
Serbia	41.0	41.0	41.5	39.3	39.5	38.9	38.3
Turkey	35.5	36.4	37.8	39.7	38.4	38.1	37.7
Total expenditure* (% of GDP)							
The former Yugoslav Republic of Macedonia	37.3	34.4	36.6	36.8	36.0	35.2	33.9
Montenegro	47.2	45.2	47.4	45.6	41.9	38.9	37.2
Serbia	45.6	46.0	47.9	44.9	45.0	43.1	40.6
Turkey	38.5	36.8	38.9	40.8	39.6	39.0	38.2
General government balance (% of GDP)							
The former Yugoslav Republic of Macedonia	-2.5	-2.5	-4.0	-3.9	-3.5	-3.2	-2.6
Montenegro	-4.9	-5.5	-6.1	-2.7	-1.3	0.2	0.9
Serbia	-4.7	-5.0	-6.4	-5.6	-5.5	-4.2	-2.3
Turkey	-3.0	-0.4	-1.0	-1.0	-1.1	-0.8	-0.5
General government debt (% of GDP)							
The former Yugoslav Republic of Macedonia	24.6	27.9	34.3	34.2	33.4	35.7	37.0
Montenegro	40.9	44.4	54.0	56.5	56.9	55.3	52.7
Serbia	44.5	50.3	60.9	62.7	65.7	68.1	67.9
Turkey	42.3	39.1	36.2	35.0	33.0	31.0	30.0

Sources: Pre-Accession Economic Programme (PEP) 2014 for 2012-2016

* 2011 data from PEP 2013, 2010 data from PEP 2012.

Fiscal consolidation across the candidate countries is expected to come mainly from expenditure restraint, but the programmes often lack detail on the underlying measures. In 2013, revenue slippages and some spending pressures necessitated the adoption of revised budget targets in Serbia and the former Yugoslav Republic of Macedonia.

In line with the target, the budget deficit in Montenegro improved substantially compared with the previous year, while it turned out lower than expected in Turkey. This was achieved thanks to a surge

in revenues following various tax rises in both countries, as well as expenditure cuts in Montenegro and higher-than-planned privatisation receipts in Turkey.

Looking forward, Western Balkan countries need to consolidate their finances in order to rein in deficits, arrest the upward trend in public debt, and rebuild fiscal buffers. Accordingly, the PEPs project budget deficits to improve, mainly thanks to spending curbs which are reflected in the forecasts for falling expenditure-to-GDP ratios. Serbia expects structural reforms affecting public administration, the pension system and the regime of public subsidies to yield savings in the medium term, but delays in implementing them could threaten the pace of fiscal adjustment.

The envisaged expenditure-led consolidation in Montenegro and the former Yugoslav Republic of Macedonia is not sufficiently underpinned by policy measures, which raises the risk that ad hoc cuts may eventually need to be made to reach the budget targets, most likely from the more flexible capital spending items.

In Montenegro, public debt will increase in line with the debt-financing of the Bar-Boljare highway, which is not accounted for in the programme and could require additional measures to achieve fiscal stability.

Even with declining deficits, public debt levels in the former Yugoslav Republic of Macedonia, and Serbia are not expected to fall over the programme period.

Additional fiscal pressures might emerge in all the Western Balkan candidate countries from state guarantees and the potential assumption of losses generated by state-owned enterprises.

Turkey's projected path of fiscal consolidation might come under pressure from lower-than-expected growth, and the lack of detail in its planned spending cuts. Even if the programme's fiscal scenario were to be realised, the moderate tightening of the fiscal stance might prove insufficient given the macro-economic need to increase national saving.

Numerous obstacles to growth and employment still need to be tackled. From persistently high unemployment to deficiencies in transport and energy infrastructure, education, a lack of competition on product markets and weaknesses in the business environment; there is no shortage of bottlenecks to long-term growth in the Western Balkan candidate countries. The PEPs reflect governments' ability to recognise such complex problems and their intention to address them with measures that include cutting red tape; stepping-up active labour market measures; overhauling labour legislation; restructuring state-owned enterprises and accelerating privatisation; improving the quality of education and health care; as well as streamlining public administration. However, a lack of focus, tight budgets, and the challenges of turning policy goals into effective action, could undermine or delay the implementation of structural reforms.

Turkey's PEP also covers reform intentions in a broad range of sectors and areas, including labour and capital markets, privatisation, energy and transport. However, it makes little mention of measures to improve the investment environment, which is arguably one of the most pressing challenges facing the country.

Part II

Country analysis

1. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

1.1. EXECUTIVE SUMMARY

Economic recovery took hold in 2013 and is likely to stay on track for the next two years. However, the programme's projection of gradually increasing annual growth rates, averaging close to 4%, appears optimistic. While domestic demand is expected to drive output growth over the next few years, private consumption growth may disappoint given the limited scope for real disposable incomes to rise significantly. The projected increase in total investment largely depends on a strong expansion of foreign investment, and the timely implementation of a significant amount of public infrastructure projects, particularly in the transport sector. The recent pick-up in FDI flows, and the confirmed pipeline of new facilities is encouraging, but ad-hoc cuts in public investments to compensate for revenue underperformance or higher than planned current spending, which happened repeatedly in the past, would need to be avoided.

In 2013, the government was forced to adopt a supplementary budget and raise its deficit target from 3.6% to 3.9% of GDP, after budget revenues had fallen short of expectations in the first half of the year, and spending pressures on welfare costs and unpaid bills had mounted. Outstanding arrears to the private sector, accumulated in 2012, had to be repaid until end-February 2013. Over the course of the year, the government amended a number of administrative and procedural budget rules, that should, if properly implemented, improve fiscal discipline and avoid a renewed build-up of arrears.

The central government debt ratio, while remaining relatively moderate, has been rising continuously since 2008, mainly because of primary budget deficits. For debt levels to remain sustainable, fiscal consolidation is required. Debt accumulated by public enterprises, and related contingent liabilities for the government as a result of debt guarantees, are a potential concern, in particular as the government shifted a large share of its spending on road construction off-budget, to a new public enterprise, with effect from January 2013.

The PEP's fiscal framework is based on the medium-term fiscal strategy adopted back in September 2013. It aims to stabilise debt by lowering the primary deficit, and envisages a reduction of the general government deficit from 3.9% to 2.6% of GDP between 2013 and 2016, mainly through cuts in current expenditure. The total expenditure ratio is expected to decline gradually, by almost three percentage points, to 33.9% of GDP. Unfortunately, the programme fails to lay out the concrete policy measures to achieve these savings. The inflexibility of current spending due to statutory requirements limits options and recent increases in pensions and announcements of further increases in social transfers may hinder the achievement of the fiscal consolidation targets. Under these constraints, current spending reductions could come from savings in the public sector wage bill, but the programme leaves open to what extent the envisaged public administration reform would achieve budget savings in the short and medium term.

The current account deficit is set to increase over the medium term. The recent volatility of remittances, which historically have helped to fund a large merchandise trade deficit, may signal a longer-lasting return to average levels following the surge seen between 2010-2012. Strong FDI, and continued government access to international capital markets on favourable terms will be needed to compensate for possible vulnerabilities arising from a potential drop in remittances.

There have been recent signs of a pick-up in lending to the private sector. Supported by a range of easing monetary policy measures, growth of total private sector credit growth picked up again in the summer of 2013, although this was, until late autumn, almost exclusively due to greater household

borrowing. Only towards the end of the year did loans to non-financial private companies start to increase. Risks to the credit outlook may derive from potential restructuring of parent banks which are systemically important for the country's banking system. The fact that domestic banks are financing themselves largely via domestic sources is reassuring in terms of financial sector stability.

The obstacles to growth and employment remain manifold. The persistently high structural and youth unemployment, shortcomings in the transport and energy infrastructure, and in the education system, administrative barriers to setting up and closing down a business, and the sluggish credit growth pose important obstacles to the further development of the private sector, including foreign investment. In particular, competitiveness and labour productivity need to be raised by increasing the innovative potential of the economy and by diversifying the export structure towards higher-end products. To this end, foreign investment facilities in higher value-added sectors need to establish stronger links with the domestic economy, as this would also help to reduce the economy's dependence on imports. The causes of high structural unemployment need to be swiftly addressed by reforms of the labour market and the education system.

1.2. ECONOMIC OUTLOOK AND RISKS

Growth is expected to strengthen further, driven by domestic demand. After the economic recovery gained firmer ground in 2013, with an estimated real GDP growth of 3.1%, the programme foresees a steady acceleration of growth from 3.2% in 2014 to 3.8% in 2015 and 4.5% in 2016. Economic performance is seen to be primarily driven by a strong resumption of investment growth beginning in 2014. Driven by major public infrastructure projects and by new foreign facilities, gross capital formation is projected to expand by above 8% on average between 2014-16. Private consumption growth is expected to be more moderate, at around 3%. Contrary to 2013 when growth was driven exclusively by net exports, between 2014 and 2016 domestic demand will become the sole engine of growth. Trade volumes are expected to pick up significantly, reflecting both, stronger imports and better export prospects. While strong import growth, resulting from the pickup in public investment and start of operations in new foreign facilities, would lead to a renewed deterioration of the merchandise balance in 2014, the start of export activity of new foreign investors and their gradually declining import needs would help narrow the trade deficit as of 2015. Overall, net exports would remain a drag on growth over the entire programme period.

Table II.1.1:

Comparison of macroeconomic developments and forecasts

	2012		2013		2014		2015		2016	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-0.4	-0.4	3.2	3.3	2.5	3.2	2.6	3.8	n.a.	4.5
<i>Contributions:</i>										
- Final domestic demand	2.3	2.3	0.7	-0.3	3.5	4.1	3.7	4.6	n.a.	5.4
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	-2.8	-2.8	2.6	3.6	-1.0	-0.9	-1.2	-0.8	n.a.	-0.9
Employment (% change)	0.8	0.8	2.7	4.3	2.0	2.5	1.5	2.7	n.a.	3.0
Unemployment rate (%)	31.0	31.0	28.9	29.1	27.8	28.1	26.9	27.1	n.a.	26.0
GDP deflator (% change)	0.2	0.2	1.5	4.3	1.8	3.5	1.6	3.0	n.a.	3.0
CPI inflation (%)	3.3	3.3	2.8	2.8	3.3	2.3	3.0	2.7	n.a.	2.5
Current account balance (% of GDP)	-3.0	-3.0	-2.3	-3.0	-2.6	-4.6	-3.0	-5.7	n.a.	-5.1
General government balance (% of GDP)	-4.0	-4.0	-4.0	-3.9	-3.8	-3.5	-3.6	-3.2	n.a.	-2.6
Government gross debt (% of GDP)	34.3	34.3	35.4	34.2	37.4	33.4	38.9	35.7	n.a.	37.0

Sources: Pre-Accession Economic Programme (PEP) 2014, Commission 2014 Winter Forecast (COM)

The PEP's growth trajectory for domestic demand appears somewhat optimistic. Despite recent and announced further increases in pensions and social transfers, private consumption expenditure could rise more slowly than foreseen in the PEP. Disposable incomes are not expected to rise significantly, with overall compensation growing sluggishly, and real net wages expected to continue their decline. While investment-led growth may result in a further increase in employment, the projected rise in total investment depends largely on the actual implementation of the significant pipeline of public investment projects, such as in the transport sector, as well as on the performance of FDI. Yet, implementation of capital expenditure projects was repeatedly hampered by mid-year budget revisions and by under-execution of budgeted amounts in recent years. After their strong decline in 2012, FDI inflows strengthened again in 2013 and, including reinvested earnings, accounted for some 3.2% of estimated GDP at the end of the year. The PEP projects net FDI inflows to gradually increase to 5% of GDP in 2016 - which is slightly above their historical average and appears somewhat optimistic even seen against the background of the government's ambitious incentives offered to prospective investors. Finally, the negative contribution of net exports could turn out to be stronger than foreseen in the programme, given the considerable import intensity of consumption and investment, and the confirmed pipeline of new, import-intensive foreign facilities in 2014 and 2015. In addition, current established FDI-related exports are concentrated in sectors with continued high import dependence, such as automotive supplies. As a result, it could take some more time than anticipated by the PEP for export volume growth to overtake import growth.

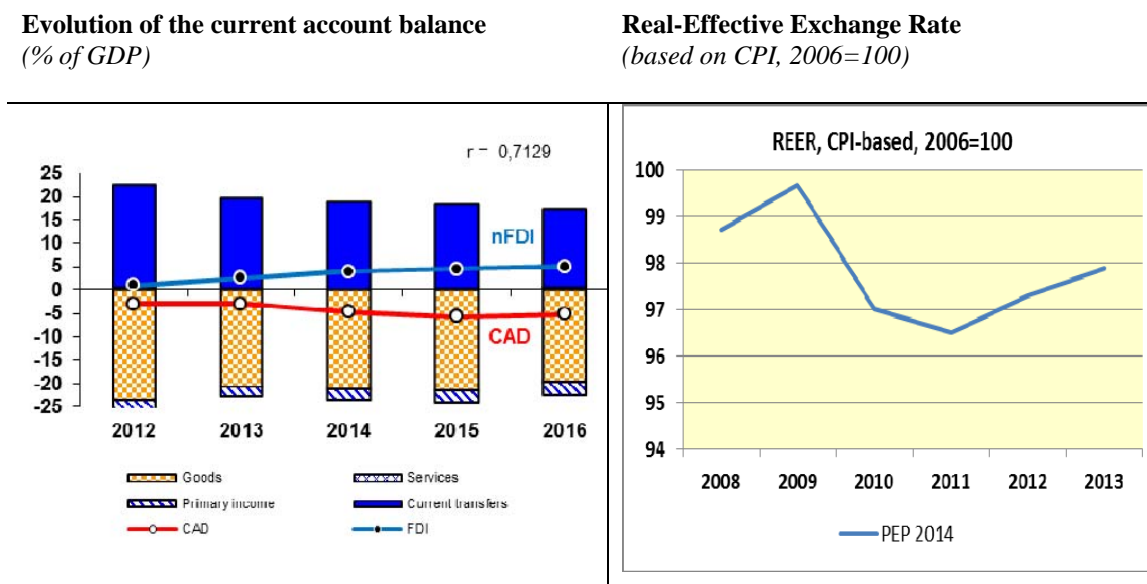
The alternative scenario fails to take into account downside risks to domestic demand. The PEP provides an alternative macroeconomic scenario based on weaker external demand from the main trade partners. This would lead to lower real GDP growth in the country by 1.1 (2014), 0.7 (2015), and 1.2 percentage points (2016), respectively, compared to the baseline scenario, resulting from a decline in the growth rates for exports and investment. This scenario could have been supplemented by another alternative scenario based on lower domestic demand, for example due to a delay in implementing structural reforms, rather than restricting the analysis to external risks, also given the fairly realistic growth assumptions for trade partners underlying the programme's baseline scenario. This assessment of the programme's content will therefore continue to rely on the baseline scenario and include references to perceived risks on the domestic side, where appropriate.

External deficits are set to rise and the high reliance on current transfers continues to be a key vulnerability. The current account deficit remained roughly unchanged in 2013, at 3% of GDP, on account of a lower trade gap and in spite of lower private transfers. It is expected by the authorities to widen gradually to 5.7% in 2015, and to narrow somewhat in 2016, when the improvement in the trade balance would outweigh the negative impact of a widening primary income deficit. The PEP's projection seems to be based on strong expectations for import-intensive new foreign capacities, while at the same time assuming a reduction in the share of private transfers in GDP, from 18% in 2013 to some 16% in 2016. While reliance on foreign borrowing to finance the current account deficit – a rising trend in recent years – has been somewhat reduced in 2013, given the surge in foreign direct investment inflows, the recent volatility in private transfers – a historically important source of current account financing for the economy, covering on average about 87% of the merchandise trade deficit in the last 5 years – may indeed signal a longer-lasting return to their average levels before the big surge that took place between 2010-2012. Strong FDI, and continued government access to capital markets on favourable terms, would be needed to compensate for possible vulnerabilities that could arise from a drop in private transfer inflows and, in view of the strong import dynamics, lead to further widening of the current account.

The external debt level is likely to stabilise and remain sustainable. Gross external debt amounted to some 66% of GDP at the end of 2013, only slightly below its share of one year earlier. According to the analysis contained in the PEP, solvency and liquidity indicators for 2013, based on three-year moving averages of GDP and exports, point to an overall improvement in the structure of external debt, as well as the debt-servicing capacity. Without providing figures, the authorities assume a

further improvement in debt indicators over the horizon, in spite of a moderate increase in external debt levels. A further increase in external debt is indeed likely, driven by government borrowing for its large public infrastructure projects, and for repayment of substantial amounts of foreign debt falling due in 2014 and 2015. Public borrowing would initially bolster international reserves, the stock of which has declined since the end of 2012, due to valuation effects, and in spite of sizeable public sector external borrowing. Reserve levels are realistically expected by the PEP to continue to provide adequate buffers against external shocks, in terms of short-term debt, and in terms of prospective imports.

Graph II.1.1: External competitiveness and the current account



Source: Pre-Accession Economic Programme 2014 (PEP)

Price stability was maintained in 2013 and pressures are likely to remain moderate. Lower food and energy prices as well as a decline in electricity prices were the main reasons for the benign inflation environment in 2013, when the average annual consumer price inflation rate stood at 3.3%. In the PEP, the authorities expect the CPI to accelerate somewhat in 2014, and to decline thereafter. This trajectory appears realistic, given expected pressures from comparatively strong domestic demand growth in 2014, while external price pressures projected to remain moderate. The projected decline in 2015 might be less marked, given expectations for continued strong growth of domestic demand and imports. International price developments are not expected to exert inflationary pressures and energy imports, which dropped in 2013, are seen to stay at current levels over the horizon by the authorities. The central bank is expected to remain committed to maintaining price stability, by successfully keeping the national currency peg to the Euro, and thus anchoring inflation expectations.

Expected output growth may have only limited impact on the labour market if structural reforms are not implemented. For 2014-2016, the programme assumes an average annual increase in employment of 2.7%, and a gradual reduction of the unemployment rate to 26% by 2016. The programme's optimistic expectations for employment are based on growing labour demand based on the strong expected pick-up in investment. Apart from the downside risks to investment dynamics –

the government's track record of subjecting public investment spending to ad hoc budget needs, and the recently-proven volatility of FDI inflows – output growth in the past did not lead to corresponding employment creation, pointing to structural impediments to employment gains, such as skills mismatches and low worker mobility between sectors and regions.

The banking sector should remain resilient despite deteriorating asset quality. Relevant financial soundness indicators point to strong resilience of the country's banking sector. Capital adequacy, measured by regulatory capital compared to risk-weighted assets, has remained stable over the last two years, at around 17%. Solvency, liquidity, and profitability indicators have also remained stable at adequate levels. However, the quality of assets on banks' portfolios started to deteriorate in spring 2012, improving only slightly again towards the end of 2013. At the end of the fourth quarter of 2013, non-performing loans accounted for 11.5% of gross loans to the non-financial sector, compared to 10.5% a year earlier. While banks' loan loss provisions more than cover the stock of NPLs, banks' profitability has suffered. Domestic subsidiaries of foreign parent banks were subject to some degree of deleveraging in past years, but this trend has recently subsided somewhat. Moreover, domestic banks are financing themselves largely via domestic sources, reducing their reliance on foreign financing. Given the resilient financial soundness indicators against the background of deteriorating asset quality, the information contained in the programme would have benefitted from a deeper analysis of the sectors that are most at risk, and the impact that loan defaults in these sectors could have on capital adequacy, liquidity, solvency and profitability. Monetary policy remained committed to supporting output and credit growth, in particular by lowering key interest rates and reducing reserve requirements for loans to energy-intensive companies and to exporters, as well as on liabilities in domestic currency. With the output gap expected by the authorities to close in mid-2014, monetary policy is now likely to reach the end of its relaxation stance.

Programme's expectations for credit growth appear optimistic. The programme expects a gradual strengthening of annual credit growth to 8.5% in 2015, from about 5% in 2013, based on expectations of improved credit risk perceptions by banks, and an end to strategically-motivated lending restraint on behalf of foreign parent banks, although the latter is rightly noted by the PEP to pose an important downside risk to the credit growth scenario. Demand for credit would be stimulated by the improved outlook for investment and private consumption. On the supply side, the scenario appears realistic, also given supportive monetary policy, as well as some government initiatives facilitating the use of land and housing property for collateral – among which the quasi-completion of the real estate cadastre, and the privatisation of land for use as collateral – which are likely to impact positively on bank's lending behaviour. Yet, there are structural factors inhibiting credit growth also on the demand side, such as the often low quality of applicants' projects.

1.3. PUBLIC FINANCE

In 2013, revenue shortfalls, spending pressures and arrears clearance required the adoption of a supplementary budget and a higher deficit. Clearance of outstanding arrears from 2012 on payments for VAT refunds and contracted works to the private sector, accounted, already early in the year, for a disproportionate share of the targeted full-year deficit. Given a shortfall of budgeted revenue in the first half of 2013, and higher than budgeted spending on transfers and pensions, the government had to adopt a supplementary budget for 2013, which raised the central government deficit target from 3.6% to 3.9% of GDP. Budget outlays were increased, in particular, for the pension and disability fund and for education. Transfers from the central government budget to the pension fund accounted for almost one quarter of total expenditure. Allocations for capital expenditure – 12% of total expenditure commitments - were also increased, by 8%, in the supplementary budget, compared to the initial commitment. However, preliminary data shows that only 82% of the revised amount was actually implemented in 2013, amounting to 3.5% of full-year GDP.

Box II.1.1.: The budget for year 2014

- * On 20 December, the Parliament of the former Yugoslav Republic of Macedonia adopted the 2014 general government budget.
- * The budget foresees a decline in the revenue ratio from 32.9% (2013) to 32.6% of GDP, and a decline in the expenditure ratio from 36.8% to 36%.
- * The general government deficit target is lowered to 3.5% of GDP, compared to 3.9% in 2013.

Main measures in the budget for year 2014

Revenue measures*

Expenditure measures**

5% increase in public sector wages

5% increase in pension benefits (0.3% of GDP)

8% increase in agricultural subsidies (0.1% of GDP)

5% increase in social benefits (0.02% of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Sources: PEP 2014

The implementation of public investment expenditure foreseen in the 2014 budget is at risk given new commitments in current expenditure. The 2014 central government budget foresees a rise in capital expenditure, in terms of projected GDP, to 4.2%. Its share of total expenditure would be almost unchanged, compared to 2013, at close to 13%. The bulk of public investment spending is earmarked for large-scale road and railway infrastructure projects. At the same time, the government increased commitments for entitlement spending in 2014. It raised pensions by an additional 2% on top of the 3% annual inflation-indexed rise; public sector wages are set to increase by 5% beginning in October 2014. Agricultural subsidies, providing income support to farmers, have also been boosted. In view of upcoming presidential elections in April, payments of social benefits and subsidies have been heavily frontloaded. One fifth of budgeted expenditure for subsidies, and 11% of budgeted social benefits, including pensions, was paid out in the first month and a half of 2014. By mid-February, according to a Finance Ministry report required in compliance with the amended electoral code, the financing gap already equalled almost half of the full-year deficit target. Hence, additional efforts in the remainder of the year, to reach the 2014 target for the general government deficit, set at 3.5%, seem required. Recent budget developments contrast with the government's declared intention to shift resources towards a more growth-friendly composition of spending. Given the track record of past years, it cannot be excluded that the realisation of capital expenditure projects falls victim to budgetary pressures -since 2006, realised capital spending has been on average some 25% below initial plans. The risk of under-execution of planned public investment spending is heightened by a lack of clear prioritisation among the multitude of donor- and budget-financed projects, and of regular reporting on the state of implementation of projects. Budget pressures may be further aggravated by

the government's over-optimistic outlook for revenue developments, against the background of the expected continued decline in real wages and the probably equally over-optimistic expectation of employment growth.

The government has undertaken some steps to improve budgetary planning and fiscal discipline, but needs to make further progress. The government introduced a number of further changes to administrative and legal rules in 2013 to strengthen public internal financial control and budgetary planning. In December, in accordance with the EU Late Payments Directive, the Law on Financial Discipline was adopted, which includes provisions for timely settlement of payments between public and private sector entities. Also, since January 2014, all budget users are required to record multi-year commitments.⁽¹⁾ However, apart from stronger budget planning capacities, more efforts have to be spent on commitment and implementation control, as well as on enhanced fiscal transparency. The government's budget planning and implementation is currently guided by the medium-term fiscal targets, which are frequently revised in mid-term. The link between the medium-term framework and the annual budget process thus remains weak, and the overall annual targets do not ensure a sufficiently growth-friendly structure of budgeted or executed public expenditure. In view of the numerous public investment projects, prioritisation of productive, growth-friendly capital expenditure needs to be reinforced. Entitlement spending needs to be better targeted towards vulnerable groups.

Table II.1.2:

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

	2012	2013	2014	2015	2016	Change: 2013-16
Revenues	32.6	32.9	32.6	32.0	31.3	-1.6
- Taxes and social security contributions	27.1	27.4	27.3	27.0	26.5	-0.9
- Other (residual)	5.5	5.5	5.3	5.0	4.8	-0.7
Expenditure	36.6	36.8	36.0	35.2	33.9	-2.9
- Primary expenditure	35.7	36.0	35.2	34.2	32.8	-3.2
<i>of which:</i>						
Gross fixed capital formation	5.3	5.7	5.8	5.3	5.5	-0.2
Consumption	12.6	12.3	11.9	11.5	10.7	-1.6
Transfers & subsidies	17.8	18.0	17.5	17.3	16.6	-1.4
Other (residual)	0.0	0.0	0.0	0.1	0.0	0.0
- Interest payments	0.9	0.8	0.8	1.0	1.1	0.3
Budget balance	-4.0	-3.9	-3.5	-3.2	-2.6	1.3
- Cyclically adjusted	-3.2	-3.3	-3.1	-3.2	-3.2	0.1
Primary balance	-3.1	-3.1	-2.7	-2.2	-1.5	1.6
Gross debt level	34.3	34.2	33.4	35.7	37.0	2.8

Source: Pre-Accession Economic Programme (PEP) 2014. Figures for 2013 are based on the Finance Ministry's projections from mid-2013.

For the medium-term, the government has ambitious consolidation plans based on cuts in current expenditure, but needs to specify policy measures Based on the Medium-Term Fiscal Strategy (MTFS) for 2014-2016 adopted in September 2013, the PEP envisages a reduction of the general government deficit from 3.9% to 2.6% of GDP over 2013-16, primarily based on reductions in

⁽¹⁾ The authorities are also conducting a Public Finance Review in cooperation with the World Bank, which is due to start in May 2014, and a related IPA project running from 2014 to 2016, both aimed at strengthening the medium-term expenditure framework.

current expenditure. The total expenditure ratio is expected to decline gradually, by almost 3 percentage points, to 33.9% of GDP. The revenue ratio is projected to fall to 31.3% of GDP in 2016, from 32.9% in 2013. Allocations for the main current expenditure items - social transfers, subsidies, and collective consumption are expected to decline as a share of GDP over 2014-2016. The expenditure-led consolidation would also affect capital spending, albeit to a smaller degree. While this consolidation trajectory seems plausible, the PEP does not provide detailed information on the policy measures that would trigger the envisaged savings in current expenditure. In general, statutory requirements for entitlement spending are comparatively high and limit fiscal space. Notwithstanding the announced rise in public wages, the government intends to keep the nominal wage bill constant through strict control of new employment, implying a declining share of the wage bill in GDP. It expects further savings from a better control of less productive expenditure, and through better targeting of social expenditure, but fails to inform about the concrete measures and the expected savings.

Off-budget shift of capital expenditure holds further risks for fiscal discipline and transparency.

Central government debt as a share of GDP remains moderate -it stood at 34.6% of GDP at the end of January 2014. Yet, there is reason for concern. Firstly, the gross debt ratio has risen rapidly since 2008 - by some 14 percentage points - and is expected to rise further over the programme's horizon, to reach 37% in 2016. Secondly, overall public sector debt is likely to be considerably higher, as a result of the development of public enterprise debt, in particular for SME financing support via the MBDP, and road infrastructure investment by the newly created Public Enterprise for State Road (PESR), to which the government moved a large part of its road infrastructure budget, previously channelled through the Road Fund (part of the central government budget) beginning in January 2013. The programme does not contain detailed information on the debt of individual public enterprises, nor on the future development of overall public enterprise debtor the division of transport infrastructure spending between capital expenditure in the budget, and the PESR. As the government guarantees a large part of the debt of the PESR, the off-budget shift, against the background of the planned increase in expenditure on road infrastructure, translates into a larger amount of contingent liabilities on the government's budget. Moreover, the government also extends debt guarantees for loans to public and private enterprises provided by the state-owned *Macedonian Bank for Development Promotion (MBDP)*. At the end of 2013, total public enterprise debt stood at about 500 mio Euro, or 6.3% of GDP, according to government information. The bank itself accounts for the major share of all state enterprise debt given its need for refinancing (between 2009 and 2013 via extensive use - 350 mn Euro - of EIB credit lines), with the rest mainly on the new PESR, which has just contracted a 550 mio Euro foreign loan to be paid out between 2014 and 2018. According to the PEP, the share of public guarantees is expected to rise significantly this year, from 6.9% of GDP in 2013, to 9.2% in 2014. Given that the public enterprises can borrow on their own behalf, the government would need to keep closely involved in their financial management to avoid fiscal risks. Formally, recruitment and investment projects of public enterprises - the latest investment program of public enterprises, spanning a 5-year period, was submitted to the government in October 2013 - are subject to approval by the Ministry of Finance. The companies report to the government on the realisation of their projects on a quarterly basis, but this information is not published. Fiscal transparency would be enhanced, and fiscal risks could be better contained if public companies reported at shorter time spans on their project implementation, and on their deficit and debt developments, and if this information would be made available to the public.

Table II.1.3:

Composition of changes in the debt ratio (% of GDP)					
	2012	2013	2014	2015	2016
Gross debt ratio [1]	34.2	34.3	33.4	35.7	37.0
Change in the ratio	6.3	0.1	-0.9	2.3	1.3
<i>Contributions [2]:</i>					
1. Primary balance	1.9	2.9	2.5	2.1	2.1
2. “Snow-ball” effect	1.0	-1.5	-1.3	-1.1	-1.3
<i>Of which:</i>					
Interest expenditure	0.9	0.8	0.8	1.0	1.1
Growth effect	0.1	-1.0	-1.0	-1.2	-1.5
Inflation effect	0.0	-1.3	-1.1	-0.9	-1.0
3. Stock-flow	2.3	-1.5	-2.2	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) 2014, ECFIN calculations

1.4. STRUCTURAL REFORMS

Measures to address the main challenges to growth and employment are subject to implementation and fiscal risks. The programme elaborates on the main areas of obstacles and necessary reforms, in particular the business environment and private sector development, and labour markets and education. In the last year, the authorities have tackled these challenges to some extent, either by regulatory measures, e.g. the facilitation of insolvency procedures; and, the continued implementation of the Regulatory Guillotine Project reducing administrative barriers for business; or, by increasing public funding, for example for further reforms of the education system. The presentation of structural reforms in the programme suggests that a number of measures initially envisaged to begin in 2013 were postponed, but it does not state the reasons for the delay. The implementation of a major initiative aimed at enhancing competitiveness, the Innovation Action Plan, lags behind due to legal requirements – the establishment of a Fund for innovation and technological development required the adoption of a new Law on Innovation Activity. According to the authorities, it became operational in the beginning of 2014. Moreover, and besides the implementation risks, the fiscal space for implementing the envisaged public investment in education and transport might be restricted, as a result of the current and projected high financing needs for the budget deficit. While spending on active labour market programmes is equally distributed among the four years 2013-2016, a highly budget-sensitive education program aiming at promoting research and innovation is heavily back loaded in the outer two years. In education, the main, budget-sensitive measure aims at increased social inclusion and integrated education, with spending heavily frontloaded. Overall, the catalogue of envisaged measures and related spending in education, labour market reforms, and innovation promotion seems large and fragmented, and the budgeted amounts could possibly lead to better results of the funded measures through pooling and synergies.

Private sector development depends crucially on stronger linkages between domestic and foreign firms. Developing the private sector with a view to increasing labour productivity and

international competitiveness remains a key challenge for the economy. After a sharp drop in 2009, followed by two years of small gains, labour productivity in the economy, in terms of output per worker, declined again in 2012 and in 2013. The majority of new jobs in recent years, including the employment gains in 2013, was created in low productivity sectors, notably agriculture and services, and in the public sector. The authorities assume a renewed, gradual increase in labour productivity between 2014 and 2016. However, realisation of these gains depends heavily on further structural change in the labour market, with a shift towards jobs with higher productivity and earnings. The government recognises this, and has been pursuing a strategy of attracting foreign direct investment in higher-value added sectors, and, at the same time, supporting local companies in developing the necessary skills to work as suppliers to the foreign facilities. While there was some indication of a shift in the FDI structure in 2013, exports have diversified only incrementally from commodities to chemicals and manufactured products with higher value added, such as machinery and electronics, and local sourcing remains limited, as a result of lengthy licensing procedures, and often missing skills and capacities required by the foreign companies. In general, companies still face difficult and costly market exit procedures, as bankruptcy proceedings remain cumbersome, even though the government has recently adopted and implemented a law which foresees swift clearing of backlog cases. Contract enforcement remains a source of concern, and calls for further capacity-building in the judicial system. Strengthening the social dialogue between government, employers and workers, by improving the capacities of the economic and social council, and of local economic councils, would give important impetus to the reform process.

Labour market reforms need to target structural rigidities. The reduction of youth and structural unemployment has been and continues to be a priority of the government's reform programme, with active labour market policies (ALMP) as the core instrument. While there is little information in the PEP about the content of ALMP measures, they have generally served to increase participation rates, and to combat unemployment in particular among vulnerable groups of workers, often in combination with skills-enhancement measures to support employability. In order to incentivize employers' creation of jobs for young unemployed, beginning in March 2014, the government has waived requirements to pay social contributions for newly recruited young workers during their first year of employment, and for these workers to pay income tax. According to the PEP, the government plans to significantly extend the scope and funding of ALMPs between 2014 and 2016. Authorities are aware of the need to improve the effectiveness and the targeting of ALMPs, but there is little indication of plans to underpin this process with regular performance evaluation of individual measures. Overall, the PEP describes a wide range of labour market-related reform measures, many of which seem rather broad in scope and would need to better target the structural obstacles to labour supply and demand, such as shortcomings in tertiary and vocational education, which often impede applicants from gaining necessary skills required on the job market; disincentives built into the labour taxation system, including appropriate thresholds for social contribution obligations, and the level of the minimum wage; lack of possibilities, or financial disincentives, for flexible work organisation; and, efficiently designed incentives for small and micro companies to register, such as a temporary alleviation of administrative and fiscal burdens. Moreover, spending commitments on some of the government's major reform initiatives – such as the *Programme for higher education and research, innovation, mobility and youth*, and the *Strategy for vocational education and training in the context of life-long learning 2013-2020*, are back loaded to 2015 and 2016, possibly leaving their implementation subject to risks of changing budgetary priorities.

Table II.1.4:
Net direct budgetary impact of key reform commitments (in EUR million)

	2014	2015	2016
Business environment	-6.3	-7.1	-0.3
Labour market	36.1	37.2	38.2
Enterprises sector	-1.1	-0.9	0.1
Financial system	-0.6	-0.5	
Agriculture	16.2	14.3	16.1
Rule of Law	2.7	-0.9	0.1
Administrative reforms	-0.7	0.0	0.6
Customs	-1.9	-0.6	-0.5
Energy	-0.5	-0.3	0.2
Transport	-2.8	-0.7	7.4
Total impact on the budget (EUR million)	41.2	40.4	62.0
Total impact on the budget (in % of GDP)	0.48	0.44	0.55

Source: Pre-accession Economic Programme (PEP) 2014

Annex: Overall Assessment of Programme Requirements

The Programme was adopted by the government on 28 January 2014, and submitted on 31 January 2014. It was drafted in consultation with the social partners.

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. The presentation includes an analysis of the external position, including development and breakdown of gross external debt, in line with Commission requests. Yet, this analysis deals mainly with trade balance developments, and would have benefitted from projections on external debt sustainability, including a detailed breakdown of external financing needs and repayment capabilities.

Fiscal framework

The programme provides fiscal projections for 2014 to 2016, in line with requirements. Data reliability is, however, limited by insufficient comparability with ESA 95 classification. 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 original 2013 budgetary estimates, not taking into account the budget revision in autumn 2013, which led to adjustments of fiscal targets. There is no information on intended revenue and expenditure measures and their likely budgetary impact. In the presentation on the structural balance, information on intended one-off- and temporary measures would have been useful to gauge more accurately the impact of discretionary fiscal measures on the economy.

Structural reforms

The authorities provide a comprehensive list of ongoing and planned policy measures in a large number of areas, and a table on the net budgetary impact of individual reform measures by policy area. The presentation does not include information on intended targets and expected results, nor on financing sources and implementation schedules. Moreover, it is not clear how these programmes relate to the categories used in the government budget.

2. MONTENEGRO

2.1. EXECUTIVE SUMMARY

Montenegro's emerged from recession in 2013 recording an expansion of its economy of 3.5% for the whole year. Growth was largely driven by net exports of electric energy and tourism services, the latter with positive spill-over effects on retail trade. A rebalancing of growth from net exports towards domestic demand, in particular gross fixed capital formation, is expected following the start of several important tourism, energy and infrastructure projects, which if successfully implemented, may set a broader base for future growth.

However, the high level of non-performing loans (NPLs) remains a matter of concern, calling for a reinforced banking supervision, as the burden of impaired loans weighs on bank capitalisation and hence, on credit supply. As a result, private consumption is expected to remain subdued in the medium term. Montenegro will launch in 2014 a voluntary financial restructuring programme (the so-called 'Podgorica approach') in an effort to reinforce the sustainability of the banking sector, public finances and real sector liquidity.

Fiscal consolidation aims to reverse the public debt trajectory and to reduce financing risks. The fiscal position of the government improved in 2013 despite the activation of substantial liabilities from the aluminium conglomerate KAP. In the medium term, the adoption of fiscal rules seems to confirm the continuity of consolidation efforts. However, the 2014 Pre-Accession Economic Programme (PEP) fails to present a clear estimation of the fiscal impact of the construction of the highway section Smokovac-Mateševo, which could oblige the fiscal strategy to consider additional measures to contain the debt and deficit within the fiscal rules limits.

The high unemployment rate requires bridging the gap between supply and demand of labour skills, strengthening active labour market policies and allowing more independent wage setting at company level. While further reforms of the labour legal framework and the education system are needed, unemployment is expected to decline in the wake of strong investment growth. Weak labour market dynamics have also been reflected in the moderation of wages, which have contracted annually in real terms since 2011, thus providing some competitiveness gain.

External imbalances have narrowed but remain very high. However, the absence of exchange rate flexibility calls for adjustment through a process of wage moderation and structural reforms leading to higher productivity. The current account deficit is being financed to a large extent by FDI inflows. However, the strong correlation between FDI and the current account deficit raises doubts about the programme's expectations of further improvements to the external position in the outer years.

Overall, the programme identifies well the main obstacles to growth but still lacks a more comprehensive and articulated strategy for structural reforms. Authorities try to address the narrow production base and weak competitiveness challenge by tackling infrastructure bottlenecks in energy, transport and tourism, in order to foster private investment and boost productivity. They also plan removing business barriers, especially for construction permits. Furthermore, there is scope for additional efforts in the product and labour markets as well as in reforms that would contribute to the sustainability of public finances, but their plans and timing for implementation remains vague.

2.2. ECONOMIC OUTLOOK AND RISKS

Conditions are set for a rebalancing of growth from net exports to an investment driven revival of domestic demand. The PEP's broadly optimistic macroeconomic baseline scenario relies on a sharp increase in investment and therefore domestic demand to replace net exports as the main engine of growth from 2014 onwards. Several important tourism, energy and infrastructure projects are in preparation. However, the short-term net contributions to growth from these investments are still difficult to ascertain given the small size of the country and its high import dependence. The Commission forecasts a lower growth path than the PEP, notably for 2014, estimating a higher import dependency of investments. Moreover, credit supply remains constrained by the high level of non-performing loans in the banking sector, restraining domestic investment and households' disposable income. Another constraint to the baseline scenario may arise from a base-effect discount in utilities and agriculture after their output surge in 2013 due to unusually favourable weather conditions.

The PEP also provides a low-growth scenario which assumes that a two-year delay in construction investments would have a negative impact on tourism, retail trade, transport and the financial sector, leading to a slightly faster decline in the current account deficit due to a reduction of construction-related imports. This scenario also assumes the liquidation of the aluminium factory KAP, anticipating a subsequent reduction of exports and a negative impact on the budget equivalent to 0.5% of GDP to finance a social programme for the workers.

Table II.2.1:
Comparison of macroeconomic developments and forecasts

	2012		2013		2014		2015		2016	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-2.5	-2.5	2.4	2.6	2.7	3.6	3.0	3.5	n.a.	3.8
<i>Contributions:</i>										
- Final domestic demand	-2.6	-2.6	-1.5	0.3	3.1	3.2	4.0	3.0	n.a.	2.8
- Change in inventories	1.2	1.2	0.5	-1.0	0.0	0.1	0.0	-0.1	n.a.	0.1
- External balance of goods and services	-1.1	-1.1	3.4	3.3	-0.3	0.3	-1.1	0.6	n.a.	0.9
Employment (% change)	2.8	2.1	1.8	2.1	2.3	1.3	2.7	0.9	n.a.	0.6
Unemployment rate (%)	19.7	19.7	19.6	:	19.2	19.2	18.5	19.0	n.a.	18.8
GDP deflator (% change)	-0.1	-0.1	-0.1	2.5	0.3	2.5	0.1	2.5	n.a.	2.5
CPI inflation (%)	4.1	4.1	2.2	2.5	2.3	2.9	2.6	2.5	n.a.	2.5
Current account balance (% of GDP)	-18.6	-18.4	-15.1	-15.4	-15.3	-14.7	-15.8	-13.7	n.a.	-12.4
General government balance (% of GDP)	-6.1	-6.1	-4.1	-2.7	-2.5	-1.3	-1.1	0.2	n.a.	0.9
Government gross debt (% of GDP)	54.0	54.0	56.8	56.5	57.9	56.9	59.0	55.3	n.a.	52.7

Sources: Pre-Accession Economic Programme (PEP) 2014, Commission Winter 2014 forecast (COM)

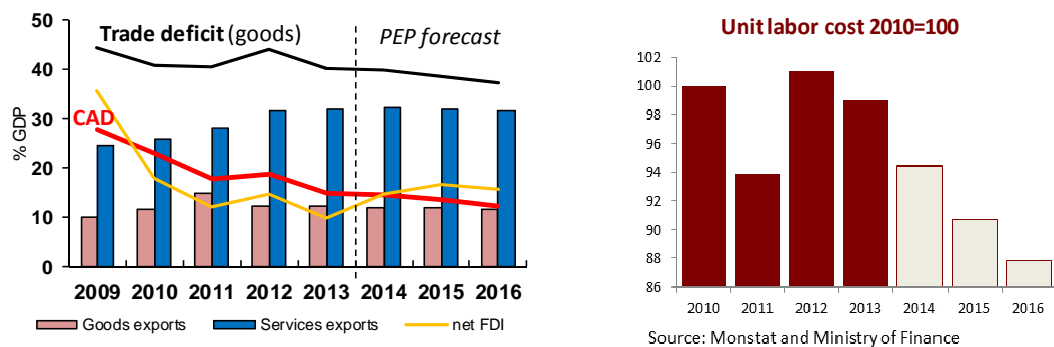
Import prices remain the key driver of inflation. Montenegro remains highly dependent on oil and food imports, which together account for some 44% of the consumption basket. Food and energy import prices have thus been setting the pace of inflation. The strength of the euro, together with lower international prices and favourable weather conditions, has reduced imported inflation from energy and food. Weak demand, resulting from tax hikes, subdued credit growth and the weak labour market also limit inflationary pressures. The main risks to the baseline scenario are the possibility of external shocks, in particular to global commodity prices, or a faster-than-expected acceleration of the economy driven by a positive output gap generated by investment flows.

Labour market imbalances reflect structural factors and weak demand. The programme foresees a mild improvement of labour market conditions thanks to spill-over effects from investments in construction towards some service activities like trade, transport, finance and insurance. However,

other sectors, such as manufacturing, might see little job improvement unless the real sector improves its liquidity constraints. Overall, the unemployment rate could fall marginally, to just below 19%, while employment improves but at a subdued rate until 2015, once the pace of investment speeds up. Weak labour market dynamics will also be reflected in the moderation of wages, which contracted by almost 4% in real terms in 2013.

Despite some adjustment, external imbalances remain large The current account deficit halved from 28% of GDP in 2009 to less than 15% in 2013 thanks to the decline of imports and –with the exception of year 2012– the growth of export revenues, particularly from tourism. As a result, the proportion of imports of goods and services paid for by exports rose from 53% in 2009 to 68% in 2013. The PEP anticipates further improvement of external imbalances thanks to higher import substitution rates of electricity and food by local production. As a result, exports of goods and services could cover 72% of imports by the end of 2016. But small economies have limited diversification possibilities, so a large range of items not produced locally must be imported. The Commission therefore foresees a resurgence of imports, driven by investment needs and a mild growth of service-led exports.

Graph II.2.1. : External competitiveness and Current account



Source: Pre-Accession Economic Programme (PEP) 2014

The current account deficit is being financed to a large extent by FDI inflows. Foreign investment remains the main and relatively stable source of external financing, as a substantial part relates to real estate rather than financial flows. Furthermore, there is a very strong correlation between FDI inflows and the current account deficit (0.93 between 2009 and 2013). This raises some doubts about the programme’s expectation that the external position will improve further in the outer years, despite the strong FDI outlook. The PEP recognises the unsustainability of these large and persistent external deficits in the long run, despite its financial coverage thus far. The absence of exchange rate flexibility calls for adjusting through a process of wage moderation and structural reforms, including more productive (i.e. greenfield) investments. The PEP offers a very schematic competitiveness analysis based on the evolution of real effective exchange rates (CPI-based) and on unit labour costs and real wages. Accordingly, the economy gained some competitiveness as a result of the reduction of salaries in real terms (by some 7% in the last four years), and according to this analysis, the decline of unit labour costs could continue in the medium term (see graph). The programme also highlights tourism as one of the sectors where competitiveness could be improved by upgrading its offer from a mass to elite product. However, it does not include other sectors with significant growth potential such as energy, transport or food production, which could be important to diversify and strengthen the local economy.

External debt remains high but with a broadly favourable structure in terms of low interest payment and short-term exposure. According to latest available data, the stock of total external debt represented 105% of GDP in 2012; a marginal increase from about 104% in 2009 and 2010. More than 90% of the external debt was denominated in euros and 40% belongs to the public sector. The annual interest paid declined to 2.7% of GDP in 2012, compared to 3.3% in the previous two years. The maturity structure seems rather favourable considering that only a small and declining fraction of outstanding debt is short-term. The percentage of short-term debt was just 7% of GDP in 2012 and 10% in 2011. Nevertheless, the external debt remains vulnerable to a sudden change in market sentiment.

Bank lending remains constrained by a high level of impaired loans. In 2013, bank lending grew by 3%, reversing a three-year period of decline. The bulk of credit is absorbed by the private sector (42% non-financial institutions, 37% households and 15% financial institutions). However, credit supply remains constrained by tight credit conditions stirred up by the high level of non-performing loans, which at the end of 2013 accounted for 18.4% of total loans, compared to 17.6% the year before. NPL distribution is asymmetric, with a substantial part concentrated in a few large banks. Montenegro will launch in the second quarter of 2014 a voluntary financial restructuring programme (the so-called 'Podgorica approach'), in an attempt to reduce payment arrears between companies, large banks, and the tax administration. However, further efforts are required for strengthening the judicial capacity and, more generally, contract enforcement.

Steady growth of overdue debts of the private sector is the biggest risk to growth in the medium term, and could threaten financial stability. This could be worsened by a re-emergence of investor risk aversion to emerging markets, following the Federal Reserve's tapering of monetary stimulus, and a withdrawal of funds from emerging economies, delaying investments and increasing banks' lending interest rates. There are also some risks related to the deleveraging of foreign parent banks which could further constrain the access to financing of Montenegrin subsidiaries, worsening the liquidity constraints of the real sector.

2.3. PUBLIC FINANCE

Budget consolidation efforts were shared between revenue and expenditure in 2013. Revenue measures accounted for 46% of the deficit improvement in 2013. These included an increase in the personal income tax rate for high earners, as well as an increase in the standard VAT rate (from 17% to 19%). Moreover, the stock of tax arrears was reduced by EUR 25 million or 0.8% of GDP. On the expenditure side, measures included a freeze of pension and public sector wages, as well as cuts in capital expenditure and transfers, although significant social expenditures have remained largely intact. As a result, budget revenue increased by a nominal 9.3% year-on-year, and the government avoided a budget revision during the year. Moreover, despite the unplanned payment of 3% of GDP in state guarantees in mid-year related to KAP, by the end of 2013 the general government deficit was brought in line with the target of 2.7% of GDP, compared to a deficit of 6% of GDP the year before.

Fiscal stability is a basic prerequisite for Montenegro's economic development. A sound budgetary position to prop up fiscal buffers is a necessity for a very small and open economy exposed to external shocks and with no exchange rate flexibility. Therefore, the continuation of the government's fiscal consolidation strategy, combined with efforts to establish an attractive environment for investment and foster growth is essential. The projection of budget revenues seems rather conservative. However, budgetary measures appear less balanced. Excluding some increase in excise taxes and some measures to reduce the informal sector, most of the consolidation effort in the medium term will rely on the expenditure side without structural reforms underpinning. In this context, the implementation of fiscal rules from 2015 could help to anchor fiscal consolidation. These rules, from the Law on Budget and Fiscal Responsibility, set upper limits for the budget deficit and

public debt at 3% and 60% of GDP respectively. The Law introduces spending ceilings restricting the expansion of current expenditures to the planned pace of real GDP growth, while capital spending increases cannot surpass the nominal GDP growth rate. To limit the build-up of arrears, unpaid commitments from the previous fiscal year shall have priority for payment. In case of excessive deficit or debt, the government will present to the parliament within 60 days a set of measures to correct the deviation.

The 2014 budget maintains a consolidation line. The government intends to freeze pensions and public sector wages for a second year, while deepening the reform of the public sector, including through a plan for restructuring local public administrations. The personal income tax hike of 2013 (so-called crisis tax) will be maintained in 2014. By contrast, the one euro tax on mobile phones, electricity metres and cable TV, introduced in 2012, has been removed (although not for restaurant's smoking areas). To compensate partially for this, the government has planned an increase in vehicle registration fees and insurance taxes. The budget also foresees a series of incentive measures, notably for facilitating repayment of tax arrears. If these consolidation measures are maintained in 2014, and considering the improved revenue results of last year's budget (with a lower GDP growth rate than foreseen for 2014) the nominal deficit target of 1.3% of GDP seems broadly plausible.

However, some risks of slippages in 2014 persist. The future of the aluminium industry, as well as its impact on public finances, remains uncertain and dependent on how KAP's bankruptcy proceedings unfold. Another risk is the rising indebtedness of the national air carrier whose debts amount to about 2% of GDP. Should the state assume its debts before privatising the company, the impact could be considerable. Due to the size of the project, the financing of the Smokovac-Matešev highway represents the major risk for public finances in the medium-term, requiring cautious control. From 2014 until 2016, budget projections only record an additional 0.8% of GDP per year in capital spending for this road project. However, an additional 2.8% of GDP in loans may also be used this year, which has not (yet) been accounted for in either the cash-based budget or the debt scenarios.

Box II.2.1.: The budget for 2014

- * The 2014 draft budget law was approved by the government on 28 November 2013 and adopted by the parliament one month later.
- * Montenegro plans to cut its budget deficit to 1.3% of GDP this year, due to expected higher nominal budget revenue supported by a 3.6% GDP expansion.
- * Both current revenue and expenditure would decline compared to the previous year budget execution, by 2.3 and 4.3 percentage points of GDP respectively. Capital expenditures should increase by 0.6 percentage point of GDP higher than in the previous year.
- * In 2014 the government will introduce a new round of fiscal consolidation **measures**, like a performance-based payment system conditioning public sector's wages adjustment to key macroeconomic and fiscal parameters, tightening sanctions against tax debtors, and further increase of tobacco excise duty.
- * The pensions and public sector wages freeze will be maintained for a second consecutive year.

Table: Main measures in the budget for 2014

Revenue measures*	Expenditure measures**
Further harmonisation of excise rates with EU (0.1% of GDP)	Non-indexation of pensions and public sector wages
Maintenance of the personal income tax rate (from 9% to 15% for salaries above national average) (0.7% of GDP)	Increase of capital budget (0.6% of GDP)
Privatisation plan for 2014 (0.5% of GDP)	Budget guarantees for infrastructure projects (0.7% of GDP)
Sale of non-financial assets of municipalities (0.3% of GDP)	Rationalisation of public administration (reduction of public sector benefits, official vehicles, and other discretionary spending)
Tighten up tax discipline	Subsidies and tax incentives for job and business creation in underdeveloped regions
Incentive programme for reduction of tax arrears (one-off repayment of principal, discounts and reimbursement with property)	Review of public procurement procedures.
Tax rate increase on real estate not in use	
Reduction of impossible tax base for private tourism accommodation.	
* Estimated impact on general government revenues.	
** Estimated impact on general government expenditure.	
<i>Source: PEP 2014</i>	

Medium-term targets are ambitious, pursuing balanced or surplus budgets. Overall, the fiscal framework foresees a continuation of 2014 trends. Thus, revenue is expected to continue declining each year by one percentage point of GDP, while the reduction of expenditure would be much faster, declining by 4.7 percentage points of GDP over the three-year period (2014-2016), to come below 40% of GDP by 2015. As a result, the budget should come close to balance in 2015 and present a small surplus of less than 1% of GDP the following year. This frontloaded fiscal adjustment scenario, while ambitious, it seems at first glance broadly plausible, unless there is an unexpected downturn in the business cycle. However, a revision of the scenario is necessary to include the financing of the highway. Moreover, the effectiveness of the new fiscal rules (to be introduced in 2015) must still be tested. If effectively implemented, they could become an additional factor supporting future budget consolidation.

Table II.2.2:

Composition of the budgetary adjustment (% of GDP)

	2012	2013	2014	2015	2016	Change: 2013-16
Revenues	41.3	42.9	40.6	39.1	38.1	-4.8
- Taxes and social security contributions	36.5	38.1	36.6	35.5	34.6	-3.5
- Other (residual)	4.8	4.8	4.0	3.6	3.5	-1.3
Expenditure	47.4	45.6	41.9	38.9	37.2	-8.4
- Primary expenditure	45.5	43.5	39.7	37.0	35.1	-8.4
<i>of which:</i>						
Gross fixed capital formation	4.0	3.3	3.9	3.8	3.7	0.4
Consumption	22.3	19.5	19.0	17.6	16.9	-2.6
Transfers & subsidies	18.2	18.4	18.5	16.9	16.0	-2.4
Other (residual)	1.1	2.3	-1.7	-1.3	-1.5	-3.8
- Interest payments	1.9	2.1	2.2	1.9	2.1	0.0
Budget balance	-6.1	-2.7	-1.3	0.2	0.9	3.6
- Cyclically adjusted	-2.9	0.0	-0.8	1.0	1.7	1.7
Primary balance	-4.2	-0.6	0.9	2.1	3.0	3.6
Gross debt level	54.0	56.5	56.9	55.3	52.7	-3.8

Sources: Pre-Accession Economic Programme (PEP) 2014, MoF update.

Public debt containment appears as a major fiscal challenge. The broadening of the tax base achieved in 2013 might have some lasting effects in the next two years, helping the budget deficit to fade away in 2015. However, this depends on the extent to which GDP growth might outpace the expansion of public spending and debt (the denominator effect), as the government starts borrowing to finance the highway in 2014. Further expansion of the public debt remains a serious risk in view of which, apart from relying on growth to soften the debt ratio, the government is preparing, with the help of international banks, an important rearrangement of the public debt in 2014. While this measure will reduce servicing costs, the borrowing for the road construction will push the debt stock above the fiscal rules limit already in 2015 (see Debt dynamics box). The stock of state guarantees remains another fiscal risk, whose activation contributed to significantly derail budget targets in the past. However, with the bankruptcy of the largest beneficiaries of these guarantees, threats have diminished too. At present, most of the recipients of state guarantees are public utilities with low business risk (e.g. electricity and water distribution). However, the threat persists from public companies of commercial character, such as the national airlines and railways. In addition, the draft fiscal rules law tolerates a rather high ceiling of 15% of GDP for the stock of state guarantees, although circumstances call for a more rigorous issuance of guarantees.

The budget is characterised by a predominance of non-discretionary spending. Wages and social security transfers account for two thirds of total expenditure. Non-productive spending (i.e. government consumption, subsidies and other expenditure) are set to further decline in real terms, while allocation for budget reserves are planned to stay at around half a percentage point of GDP yearly. Debt interest servicing should remain manageable, at around 2% of GDP, although the growth trajectory of the public debt stock offers reason for concern. The revenue side has been calculated at a similar level to 2013, except for VAT, excise and social security contributions income, which are planned to rise in the later years broadly in line with real GDP growth. The tax burden should be further reduced by the continuation of measures to fight the informal economy and collection of unpaid taxes. The introduction of fiscal rules (see above) as well as the adoption of the European System of Accounts (ESA10) could further reinforce public finance too.

Box II.2.1.: Debt dynamics

The stabilisation of public debt is being deferred and could easily exceed fiscal rules limit. In 2013, public debt reached 56.5% of GDP, increasing by 2.5 percentage points of GDP, compared to 8 points faster expansion a year before. The main reason for this deceleration is the lower budget deficit. However, like in past years, stock-flow adjustments from activation of state guarantees on bankrupt companies, contributed to the increase of both domestic and external indebtedness as local as well as foreign bridge loans were solicited.

The recovery of growth as of 2013, together with favourable inflation effects, could help to slow-down public debt growth, in particular from 2014 onwards, when primary balances turn positive with a denting effect in public debt. In the low-growth scenario, the decline of debt is not expected before 2016.

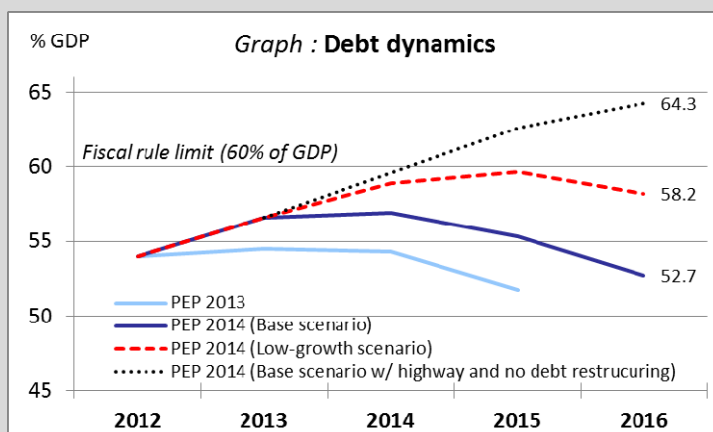
Composition of changes in the debt ratio (% of GDP)					
	2012	2013	2014	2015	2016
Gross debt ratio [1]	54.0	56.5	56.9	55.3	52.7
Change in the ratio	8.1	2.5	0.4	-1.6	-2.6
<i>Contributions [2]:</i>					
1. Primary balance	3.7	1.9	-0.9	-2.1	-3.0
2. “Snow-ball” effect	3.1	-0.5	-1.0	-1.4	-1.3
<i>Of which:</i>					
Interest expenditure	1.9	2.1	2.2	1.9	2.1
Growth effect	1.2	-1.3	-1.9	-1.9	-2.0
Inflation effect	0.0	-1.3	-1.3	-1.4	-1.3
3. Stock-flow	1.3	1.1	2.4	1.9	1.6

Notes:

[1] End of period.

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

Source: Pre-Accession Economic Programme (PEP) 2014, ECFIN calculations



The Bar-Boljare highway represents a development opportunity as well as a fiscal risk. The government of Montenegro obtained favourable conditions for a loan covering 85% of the EUR 810 million total cost of the 44 km section (Smokovac - Mateševo), offering a grace period of 5 years, repayment of 20 years and a fixed interest rate of 2%. The remaining 15% (or EUR 120 million) would be financed from Montenegro’s capital budget. Overall, public debt seems –all things equal– bound to easily overrun the fiscal rule limit in

2015, when including the borrowing cost for constructing the highway in the baseline scenario. In such case, according to the (draft) fiscal rules, the government should propose to the parliament a debt reduction programme.

Montenegro is considering a debt-refinancing plan to reduce its external financing vulnerabilities. In 2014, the government will borrow more than planned for this year budget financing, hoping for better terms so that it can refinance two Eurobond issues maturing in 2015 and 2016 worth more than 5% of GDP each. The potential refinancing could reach 50% of the existing

liabilities. Without a rearrangement, Montenegro would need to borrow 6.8% of GDP in 2014, 12% in 2015 and around 9.6% in 2016 for refinancing its budget and debt.

So far, debt servicing costs are not a significant burden for public finances. They represent around 2% of GDP due to the high proportion of borrowing on concessional terms. The external public debt accounts for 43% of GDP, of which three quarters are held by foreign creditors. Of these, loans from international financial institutions and European government institutions with favourable conditional terms account for almost half. The two Eurobond issues mentioned above represent one quarter, and the remainder is owned by foreign private banks under commercial conditions. Domestic debt represents 13% of GDP, of which almost half is owned to commercial institutions and the rest corresponds to different Montenegrin government bonds⁽¹⁾ under favourable conditions.

2.4. STRUCTURAL REFORMS

Montenegro is faced with significant structural obstacles to growth. Liquidity in the economy is unsatisfactory due to the large proportion of NPLs, insufficient bank lending and high interest rates. Much of the high unemployment rate is structural, resulting from labour market mismatches. Montenegro also has a narrow export base and still has a significant amount of industrial restructuring to go through. The regulatory burden is stifling, particularly at the municipal level and there is a general need to improve the competitiveness of the economy.

These challenges are well identified and so is the direction of the needed reform priorities However, the programme appears sometimes more detailed on secondary measures, while remaining rather vague on more substantial reforms, such as the planned amendment of the Labour Law, that was simply announced. Some reforms, such as those targeting the business environment, seem broadly advanced, although some important parts, like reduction and simplification of municipal taxes, fees and construction permits, have yet to be implemented. Other reforms, like education, remain practically stuck. The challenge of creating a more efficient and streamlined public administration is addressed now under a new angle, underlining its role of service towards businesses, and also including the local administrations, which until now have been largely spared.

The link between specific measures and the fiscal framework remains the main weakness of the reform programme. Without a correct estimate, the PEP cannot become a useful tool for public finance management. In spite of some progress in the evaluation of the fiscal impact for a few reforms, which present multi-annual estimates for the revenue as well as the expenditure impact, the large majority continue to present at most their budgetary expenditure allocation for the current year only. The sequencing of reforms also appears limited to specific policies, usually referring to the adoption of legislation, followed by related secondary legal acts. Some reforms are announced in the context of annual plans (like sector strategies, budgets or privatisation agendas), but prioritisation or coordination between different administrations is not apparent yet.

⁽¹⁾ Namely, restitution bonds, foreign frozen currency savings bonds, pension arrears and labour fund obligations.

Table II.2.3:

Net direct budgetary impact of key reform commitments (in EUR million)			
	2014	2015	2016
Privatisation	17.0	22.0	12.0
Competition policy and state aid	-1.5	n.a.	n.a.
Business environment	-0.1	-0.1	-0.1
Network industries	-59.1	n.a.	n.a.
Labour market	-12.9	-17.1	-17.1
Education* and Research	-5.3	-10.3	-11.2
Pension system	-137.0	-164.0	-145.0
Healthcare system	-8.3	-10.3	-9.9
Social protection	63.1	59.4	58.7
State administration	14.5	14.5	13.5
Other measures	-23.8	n.a.	n.a.
Total impact on the budget	-152.0	-138.7	-115.1
Total impact on the budget (in % of GDP)	-4.3	-3.7	-2.9

Source: Pre-Accession Economic Programme (PEP) 2014, ECFIN calculations
* Data for Education reform not available

The major risk for effective implementation of the reforms is the possibility of delays, rather than cancellation or sudden changes of priorities. Although the reforms are not very detailed, the authorities' commitment for their implementation (although at different speeds) has so far been consistent. Nevertheless, some delays have occurred. The reform of the education system has been delayed due to budget cuts and some planned privatisations have been postponed because of a lack of investor interest. Other reforms, including pensions or the labour law, have been announced yet again with a view to further improve their results but their timetables remain imprecise.

In the area of product and capital markets the key problem is a lack of competitiveness and of liquidity of the economy. To address this challenge, privatisations will continue with the aim of improving the business environment by raising the efficiency of state-controlled companies, encouraging foreign investment and stimulating growth. However, the scope for success appears limited, as many of the companies listed for privatisation have already been offered –unsuccessfully– one or more times for sale. Meanwhile, the government will continue offering concessions of former military sites to develop large upscale tourism projects. Another tool for improving competitiveness is to ensure a level-playing field for companies. The PEP foresees a strengthening of competition through targeted state aid for research, development and innovation after having already established (in 2013) the first regional business centres, business incubators and centres of excellence.

Other important obstacles for entrepreneurs are the costs of building permits and municipal fees, as well as the resolution of business claims. In early 2014, the government adopted the recommendation of the Council for Regulatory Reform and Improvement of Business Environment to abolish municipal fees on construction permits, and to compensate municipalities from the resulting loss of income through property taxes. Enforcement of civil decisions remains weak, but the first bailiffs for civil enforcement of claims have been recruited recently. Also in 2014, the Central Bank with the support of the World Bank, will launch a voluntary financial restructuring programme to reduce payment arrears. The reorganisation of the public sector started with the preparation of the Law on Civil Servants and Public Employees as well as of the Law on Salaries of Employees in the Public Sector. The objective of this law (to be adopted in 2014 and implemented in 2015) is to use the same

wage scale for all public sector jobs, including regulatory agencies and public enterprises. An important measure in support of budget sustainability is the introduction of saving measures, including public sector's wages or jobs cuts should the budget deficit reach or exceed 2% of GDP.

The development of network industries appears as a key driver of growth in the coming years.

Lack of quality infrastructure has been for long a stumbling block in Montenegro's development. The construction of several energy projects, financed by the private sector and public utilities, should enable the country to eliminate its current electricity deficit and become a net exporter. The obsolescence of municipal waste and water utilities has been another obstacle to the development of a high-end tourism industry. At present, several projects are planned or under construction, financed through multilateral loans backed by state guarantees. The Smokovac-Mateševo highway project will be the most important in terms of its fiscal impact. The highway will address the need for modern, safe and fast transport connecting the Northern region with the capital and the coast.

Labour market reforms require more resolute action.

The high unemployment rate of nearly 20 %, with a high proportion of youth unemployment remains an obstacle to growth and productivity. A specificity of Montenegro is that tens of thousands of work permits are delivered each year to non-residents, despite the fact that not all the seasonal job vacancies for local workers are filled. The measures announced in the PEP are mainly a continuation of subsidised jobs and training by the employment agency, including young local workers for seasonal jobs, as well as an annual traineeship programme for university graduates to acquire work experience and thus improve their chances of employment. In Montenegro, the same national collective agreement applies to both private and public sector, adding to labour market rigidity. While the implementation of the pension system reform started in early 2014 (raising gradually the age limit for retirement to 67 years for both men and women), the PEP also announces a revision of the indexation of pensions but without providing further details. The reform of the education system has been delayed due to budget constraints. Although a National Qualifications Framework and a system for continuous monitoring of graduates careers are planned for 2014, there are no budget estimations in the PEP for the implementation of education reforms.

Annex: Overall Assessment of Programme Requirements

Montenegro's third Pre-Accession Economic Programme (PEP 2014-2016)⁽¹⁾ presents a comprehensive and broadly consistent outline of the medium-term macroeconomic and fiscal frameworks based on the projection of a gradual acceleration of growth. The key objective remains unchanged compared to the previous PEP, namely the consolidation of public finances and creation of conditions for rapid economic development through the improvement of the business environment. The document broadly complies with the Commission's requirements, and reflects some further improvement of analytical capacities. Although there is also some effort to complete all the statistical requirements, there is some incomplete data in some of the annex statistical tables. The PEP was adopted by the government (on 9 January 2014). It shares with the country's annual budget the same macroeconomic and fiscal frameworks.

Macro framework

The macroeconomic scenario is more elaborated than in the previous year. The analysis of potential growth has been supplemented this year with a brief analysis of competitiveness based on labour costs and price dynamics, as well as an overview of the tourism sector competitiveness and a first analysis of the external sector and its medium-term sustainability. However, the lack of data on private external debt impedes the calculation of the net external position of the country and the simulation of external shocks scenarios. The rationale underlying the development of the sources of growth has been largely based on gross value added components, but also includes this year the components on the expenditure side. As in previous years, the PEP also presents an alternative low-growth macroeconomic scenario stressing the negative consequences of delayed investments.

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 2014. However, underlying measures for 2015-2016 could be clearer and their specific fiscal impact estimated. The PEP low-growth fiscal scenario seems somewhat more realistic than in the past, since it does not expect any budget surplus or fast recovery in the last year of the programme. However, while revenue is expected to decline, no expenditure consolidation is foreseen and expenditures would remain at the same level in both scenarios. Fiscal data is not in line with ESA standards, although the authorities have been reminded of this requisite in the context of EU accession negotiations. No fiscal notification was submitted by Montenegro in 2013.

The programme sensitivity analysis proceeds to compare the base scenario against the occurrence of these risks. Deviations compared to the previous year PEP are explained by adjustments in the assessment of GDP growth rates (i.e. contraction deeper than expected in 2012), as well as on fiscal parameters by the unforeseen activation of state guarantees.

Structural reforms

The structural reform section reports for the first time on the main obstacles to growth. To address these challenges, the programme presents a series of reforms and report on their degree of implementation, future measures planned as well as -in some cases- a rough estimate of their budgetary impact (although often partial and mostly on the expenditure side). As in previous programmes, some sections are more detailed than others, although some simplification has helped to diminish the large disparities in quality and detail observed in the past. Measures are better detailed,

⁽¹⁾ Montenegro's programme is originally labelled 2013-2016 reflecting the year of government approval (2013) instead of the submission year (2014).

especially past ones, as well as those related to the current budget. However, they are insufficiently defined for the outer years, lacking also an explicit timetable. Moreover, the link between the fiscal framework and specific reform measures needs to be better elaborated, including their medium-term fiscal impact and competitiveness gains. The programme did not include any reference to the Commission's Progress Report.

3. SERBIA

3.1. EXECUTIVE SUMMARY

The economic recovery remains fragile with significant downside risks. Following an export-led resumption in 2013, economic growth is expected to slow down and remain modest over the programme horizon. The envisaged growth profile depends crucially on increased investment, linked to the country's EU accession prospects, an acceleration of domestic reforms, and a steady growth in exports, supported by rising external demand and improved competitiveness. Strong exports have led to a significant reduction of the current account deficit in 2013, which nevertheless remains structurally high. In an environment of weak demand, inflation is set to decline, although its volatility still needs to be addressed in a sustainable manner. High unemployment, above 20 % of the labour force, remains a key concern as any gains in private sector employment are likely to be largely offset by job losses due to public sector restructuring.

Fiscal consolidation is a key policy challenge. The 5.0 % budget deficit in 2013 far exceeded the initial target of 3.6 % of GDP. Budget execution was marked by significant revenue underperformance brought about by increased tax avoidance and a revenue-poor structure of growth. The overall deficit was contained only through across-the-board cuts to current and investment expenditure. Despite a new round of consolidation efforts, increased spending is foreseen to keep the planned deficit high at 5.5 % of GDP in 2014. However, a number of risks call for a cautious execution of the budget and revisiting both revenue and expenditure to identify additional savings already this year. Although largely appropriate, the fiscal consolidation path envisaged in the programme will require additional efforts and needs to be further strengthened and frontloaded as the measures backing it are progressively less specified and subject to higher uncertainty. Timely implementation of the proposed measures will be essential to enhance the credibility of the programme, which has been undermined by persistent implementation delays in previous years.

Structural weaknesses are manifold, ranging from a bloated public sector, poor infrastructure, a rigid labour market, an unfriendly business environment, and insufficient competition in certain sectors. The authorities are well aware of the magnitude of the challenges and bold measures to improve the business environment and support private sector development should be adopted with urgency. Completing the restructuring of state-owned enterprises is long overdue and further significant gains could be reaped in the public sector at large. In addition to reducing subsidies, the programme also foresees a review of all state aid provisions. The modest and narrow-based economic recovery has so far failed to relieve the banking sector from its high level of non-performing loans and the financial system is expected to remain under pressure. As the success of the reforms hinges to a large extent on creating new jobs and a more dynamic labour market, decisive measures are needed to overcome obstacles to job creation. Sufficient funding for redundancy programmes and active labour market measures also need to be provided. Finally, core public system reforms, like administration and pensions should provide the backbone of fiscal adjustment. Therefore, it is welcome that the programme outlines an ambitious public administration reform and, although not expected to bring immediate savings, parametric pension system reforms, as these are indispensable for a sustainable reduction of budget deficits over the medium-to-long term.

3.2. ECONOMIC OUTLOOK AND RISKS

Following an export-led recovery in 2013, economic growth is expected to slow down and remain modest over the programme horizon. The PEP foresees real GDP growth of 1 % in 2014,

accelerating to 1.8 % and 2.0 % in the outer two years. Private and government consumption are forecast to act as a drag on growth throughout the whole period, as fiscal consolidation efforts and low net job creation undermine disposable income. A robust increase in investments of 7.7 % on average over 2014-2016, along with steady exports expansion of 7.1 % on average will be the sole engines of the economy. Low growth is seen as turning only slowly the tide on the labour market, where gains in employment would be largely offset in the first two years of the programme by public sector lay-offs. Suppressed domestic demand, a broadly stable exchange rate, and reduced food price volatility, are expected to keep inflation on a declining path and within the central bank target tolerance band. The current account deficit fell by more than half in 2013 and the programme assumes that external imbalances would continue falling, albeit at a slower pace.

Table II.3.1:

Macroeconomic developments

	2012		2013		2014		2015		2016	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	-1.5	-1.7	2.1	2.0	1.3	1.0	2.2	1.8	n.a.	2.0
<i>Contributions:</i>										
- Final domestic demand	1.6	-1.9	-3.5	-2.3	0.5	-0.9	2.3	0.8	n.a.	1.2
- Change in inventories	-2.8	1.2	0.3	0.0	0.0	0.0	0.1	0.0	n.a.	0.0
- External balance of goods and services	-0.3	-1.0	5.2	4.3	0.7	1.9	-0.1	1.0	n.a.	0.8
Employment (% change)	-1.1	-1.1	3.7	-0.7	0.0	0.0	0.8	1.0	n.a.	2.0
Unemployment rate (%)	23.9	24.6	22.1	25.0	22.3	25.7	21.4	25.7	n.a.	25.0
GDP deflator (% change)	6.0	7.4	6.3	8.9	4.5	5.5	5.0	5.2	n.a.	4.7
CPI inflation, annual average (%)	7.3	7.8	7.9	8.4	4.3	5.5	5.0	5.2	n.a.	5.0
Current account balance (% of GDP)	-10.6	-10.5	-4.9	-6.0	-4.7	-4.5	-4.8	-4.0	n.a.	-3.5
General government balance (% of GDP)	-6.5	-6.4	-4.9	-5.6	-5.9	-5.5	-5.2	-4.2	n.a.	-2.3
Government gross debt (% of GDP)	60.0	60.9	63.4	62.7	70.0	65.7	72.8	68.1	n.a.	67.9

Sources: Pre-Accession Economic Programme (PEP) 2014; for 2012 and 2013 the latest official national statistics where possible. Commission Winter 2014 forecast (COM)

The macroeconomic scenario is plausible and major uncertainties and risks are clearly outlined and recognised by the programme. The baseline scenario is built on the assumption that a number of key structural reforms will be implemented. However, early parliamentary elections, which took place in mid-March, have delayed the envisaged reform agenda. Further delays or weakening of authorities' resolution to pursue the plans to improve the business environment, strengthen competitiveness and reduce budget deficits over the medium term could seriously undermine growth. In view of heightened uncertainty and risks, the programme presents an alternative macroeconomic scenario with a recession in 2014, followed by a tepid recovery thereafter.

The process of rebalancing the economy away from consumption to exports and investments is likely to continue. Fiscal consolidation efforts and a weak labour market will continue to depress consumption. A steady population decline of about 0.5 % per year will also dampen consumption. On the other hand, after a stellar performance in 2013, driven mainly by a single car assembly project, export growth is expected to be supported by improving external demand in Serbia's main trading partners. However, the envisaged acceleration of export growth in 2015-16 appears optimistic in view of base effects and the lag between the foreseen build-up of investment activity and increasing export capacity.

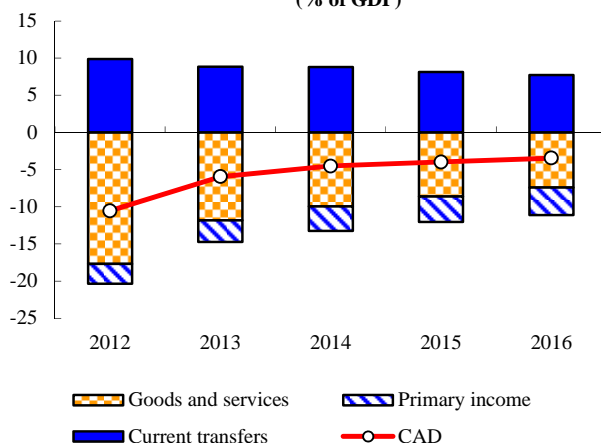
Investments are expected to receive a boost from better EU accession prospects and from reforms aimed at improving the business environment. The opening of EU accession negotiations,

as proven by previous enlargements, could be a game-changer for Serbia's prospects in attracting investments. This process is expected to be supported from the second half of 2014 by a number of measures to improve the business environment, such as a simplification of construction permit procedures, reducing red tape and measures to reduce labour market rigidities. In line with that, the programme assumes a slow acceleration of foreign direct investments, to an average of about EUR 1.4 billion a year over the programme horizon — still below their pre-crisis levels. In 2014, investments are also likely to be propped by a recovery in government capital spending, which had reached a low of 2.3 % of GDP in 2013. However, the foreseen upswing in investment activity could be stymied by further delays to structural reforms, or by a weaker-than-expected recovery in the EU, which over the last decade has been by far the biggest source of foreign direct investments.

Inflation is set to decline, although the factors driving its volatility still need to be addressed in a sustainable manner. It is expected that weak demand, a relatively stable exchange rate, and increased food price stability will dampen inflationary pressures, while adjustments in administered prices are foreseen to continue pushing the price level upwards over the programme horizon. Food prices have been extremely volatile in recent years, reacting strongly to weather conditions. However, the reduction of duties on food imports from the EU in the beginning of 2014 should bring more stability to this major component of inflation. The dinar exchange rate, another key determinant of inflation, is expected to balance between medium-term appreciation pressures, related to increased foreign investment inflows, and transient depreciation episodes linked to external factors or bouts of domestic policy uncertainty. Inflation expectations have declined recently but in order to anchor them further, stronger competition on product markets and continued fiscal consolidation efforts will be crucial.

High unemployment is a key policy concern. Although Labour Force Survey data suggest a marked improvement of the labour market in 2013 with unemployment falling to 22.1 % from 23.9 % in the previous year, the actual situation is less clear. There are wide and growing discrepancies between different sources of data about the labour market. For example, the number of registered unemployed continued to increase throughout the year and registered employment declined by 0.6 %. As investment activity strengthens and administrative rigidities are addressed as planned, the labour market is expected to become more dynamic. However, any gains in private sector employment are likely to be largely offset by job losses due to public sector restructuring and the unemployment rate is expected to remain very high. Managing the social and regional implications of high unemployment would require a sustained commitment from the budget and active labour market measures to address youth and long-term unemployment, in particular.

Graph II.3.1: Evolution of the current account balance (% of GDP)



Source: Pre-Accession Economic Programme (PEP) 2014

Important progress has been made towards reducing external imbalances, although they still remain structurally high. The current account deficit more than halved in 2013 to about 5 % of GDP, with exports contributing about two-thirds of the adjustment. Despite continuing fluctuations since 2007 and a bout of appreciation last year, the real effective exchange rate has stayed close to its medium-term average and has not undermined competitiveness. Imports growth has remained subdued due to weaker-than-expected demand and import substitution in oil derivatives production. As recovery in domestic demand gathers pace, the PEP foresees a rather moderate acceleration of imports growth and a continued reduction of the current account deficit. However, in view of the envisaged strong investment growth and the stabilisation of private consumption forecast towards the end of the programme horizon, imports are likely to increasingly counterbalance exports. Nevertheless, external competitiveness is set to improve further as advances in public sector restructuring, new investments, and general improvements in the business environment provide opportunities to increase productivity, while a weak labour market puts a cap on unit labour costs. Labour cost increases may be further limited in industries with active state-owned enterprises, which are likely to shed labour and limit wage growth over the short-to-medium term.

Rising external liabilities of the public sector pushed the net international investment deficit to a new high of almost 100 % of GDP in 2013. The government's decision to rely increasingly on foreign borrowing to finance its budget deficit stood out in an environment of relatively meagre financial flows. Non-government portfolio and other investments were negative, while foreign direct investment remained low, covering about half of the current account deficit in 2013. As economic growth is forecast to remain modest and the current account to stay negative over the medium term, the net international investment position will most likely continue to deteriorate slowly. By the end of 2013, Serbia boasted significant foreign exchange reserves, covering about seven months' worth of imports and providing an important cushion against future market turbulence. Maintaining a relatively high level of international reserves is particularly important given recent tensions affecting emerging markets, resulting from the uncertainty created by the US Federal Reserve's decision to taper its quantitative easing. Adequate reserves are also needed to provide a buffer for the Serbian central bank's interventions to smoothen daily volatility on the foreign exchange market.

The financial system is expected to remain under pressure. The modest and narrow-based economic recovery has so far failed to relieve the banking sector from its high level of non-performing loans, which increased to 21.4 % by the end of 2013. Although the system as a whole remains well-capitalised, four banks, three of which were state-owned, failed to meet the minimum capital requirements and the central bank has revoked their licences over the past 18 months. The bailing out of depositors and preserving financial stability has come at a high price for the state, approaching EUR 1 billion (around 3 % of GDP), which led the authorities to initiate a process reviewing the overall financial stability framework. In this regard, governance issues deserve particular attention. Lending fell in real terms in 2013 and over the short-term is expected to remain stagnant. Although direct effects on investment activity are likely to be limited because more than two-thirds of payments for investments in fixed assets have been funded by own resources and only about a fifth by financial credits, a sustained economic recovery would require a rebound in credit activity.

Table II.3.2:
Financial sector indicators

	2009	2010	2011	2012	2013
Total assets of the banking system, mEUR	29,791	32,422	35,089	34,980	34,402
Credit growth	21.4	32.3	5.5	12.9	-6.5
Deposit growth	23.6	14.4	9.2	10.4	3.4
Loan to deposit ratio	1.2	1.4	1.3	1.4	1.2
Financial soundness indicators					
- non-performing loans	15.7	16.9	19.0	18.6	21.4
- total provisions to gross NPLs	168.1	149.4	129.2	126.5	117.9
- regulatory capital to risk weighted assets	21.4	19.9	19.1	19.9	20.9
- liquid to total assets	34.1	27.2	25.4	23.9	26.1
- return on equity	4.6	5.3	6.6	4.9	-0.1
- forex loans to total loans*	75.8	76.8	69.8	74.1	71.6

Sources: National Central Bank, DataInsight. * includes both denominated and indexed positions.

3.3. PUBLIC FINANCE

The 2013 budget deficit of 5.0 % of GDP greatly exceeded the initial target of 3.6 %. Still, the outcome was below the revised supplemental budget target of 5.3 % of GDP and much lower than the 2012 deficit of 6.6 % of GDP. Budget execution was marked by significant revenue underperformance. Increased taxation of consumption and corporate income, including a VAT hike from 18 % to 20 %, introduced at the end of 2012, failed to bring the expected results and total revenue as a share to GDP fell by 1.4 percentage points to 40.6 %. In addition to increased informalities and tax avoidance, a revenue-poor structure of growth, based exclusively on exports, and a lower-than-foreseen private consumption deflator, were the main factors explaining this underperformance.

The 2013 deficit was contained only by across-the-board cuts to current expenditure and investment. These cuts contributed almost equally to a 3.0 percentage point reduction in the total expenditure-to-GDP ratio to 45.6 % of GDP. Fixed indexations of salaries and pensions, below the rate of inflation, brought down the spending on these two categories, although they still remain elevated, accounting for more than half of total expenditure. Savings efforts were also made in other spending lines, notably on those related to the newly-introduced procurement legislation, like goods and services and on investments. The worst hit, however, was investment, which was cut by about a third from its medium term average, to around 2.3 % of GDP. Interest expenditure reached a new high of 2.6 % of GDP, eating up a quarter of the space created by consolidation efforts.

Embattled by high deficits, the authorities aim to gradually slow down the growth of public debt. The government aims to keep public debt below 70 % of GDP throughout the programme and has proposed a number of fiscal consolidation measures and structural reforms to reduce the budget deficit to 2.3 % of GDP in 2016, or by 3.3 percentage points between 2013 and 2016. If other expenditures recorded below the line, such as servicing activated guarantees, bailing out depositors in failed banks, assumption of obligations from other entities, and spending related to the restructuring of state-owned enterprises, are taken into account, the budget deficit is forecast to fall from 7.1 % in 2014 to 3.2 % of GDP in 2016. The consolidation path is primarily expenditure-based, although due to additional reform costs in the first year it is rather back-loaded, starting only in 2015.

The envisaged adjustment path would require additional efforts and needs to be further strengthened and frontloaded. The measures underlying the programme's consolidation scenario are progressively less specified and subject to higher uncertainty. In 2014, a quarter of the structural adjustment, accounting for 0.4 % of GDP, depend on reducing the shadow economy. In the following two years, more than 70% of the expected adjustment, accounting for 2.25 % of GDP, is foreseen to come from debt refinancing, reducing the shadow economy, and reforms of the public administration and pension system, which would require significant further actions by the authorities.

Table II.3.3:

Composition of the budgetary adjustment (% of GDP)

	2012	2013	2014	2015	2016	Change: 2013-16
Revenues	41.5	39.3	39.5	38.9	38.3	-1.0
- Taxes and social security contributions	36.2	34.8	35.4	34.9	34.5	-0.3
- Other (residual)	5.3	4.5	4.1	4.0	3.8	-0.7
Expenditure	47.9	44.9	45.0	43.1	40.6	-4.3
- Primary expenditure	45.9	42.3	42.0	40.5	37.7	-4.6
<i>of which:</i>						
Gross fixed capital formation	3.7	2.9	3.3	3.6	3.1	0.2
Consumption	19.2	18.1	17.9	16.7	15.8	-2.3
Transfers & subsidies	23.0	21.4	20.7	20.2	18.9	-2.5
Other (residual)	0.0	-0.1	0.1	0.0	-0.1	0.0
- Interest payments	2.0	2.6	3.0	2.6	2.9	0.3
Budget balance	-6.4	-5.6	-5.5	-4.2	-2.3	3.3
- Cyclically adjusted	-5.7	-5.4	-5.3	-4.2	-2.6	2.8
Primary balance	-4.4	-3.0	-2.5	-1.6	0.6	3.6
Gross debt level	60.9	62.7	65.7	68.1	67.9	5.2

Sources: Pre-Accession Economic Programme (PEP) 2014, ECFIN calculations.

Despite a new round of consolidation efforts, the authorities expect increased expenditure to keep the deficit high at 5.5 % of GDP in 2014. The budget includes new consolidation measures to the tune of 1.6 % of GDP, split almost evenly between the revenue and expenditure sides. Additionally, in January, the government adopted a hiring freeze in the public sector, which should help cut spending by as much as 0.2 % of GDP in 2014. However, higher interest payments, investment expenditure, new subsidies, and social costs, mainly related to the planned finalisation of public enterprise restructurings, are expected to keep total spending and the budget deficit very high. If the aforementioned 'below the line' payments are included, the targeted deficit would jump to 7.1 % of GDP.

A number of risks call for a cautious execution of the 2014 budget and additional efforts to further reduce the primary deficit. Although revenues have been forecast on the basis of a plausible macroeconomic scenario, the possibility of lower-than-expected inflation poses a major risk. This, along with uncertainty related to the effects of some of the proposed measures, like fighting the shadow economy, calls for additional prudence in expenditure execution. Expenditures could also be a source of tension, having in mind potential delays in adopting a set of business-friendly legislation and the tight deadline for completing the restructuring of public sector enterprises by mid-May. As a result, there may be a need to identify additional savings, while trying to avoid another slump in government investment.

Fiscal adjustment in the later years of the programme should be based on a timely implementation of sustainable and long-term reforms. Striking the right balance between the speed of budgetary adjustment, economic recovery, sequencing and pace of structural reforms, will be extremely challenging. Although largely appropriate, the pace of fiscal consolidation envisaged in the

programme could be threatened by persistent delays in implementing reforms, as observed in previous years. It will, therefore take additional efforts to enhance the credibility of the proposed measures. In particular, the timely design and introduction of harmonised rules and procedures for pay and grading of public sector employees and a reassessment of the public sector's employment needs will be key, as this is the single most important consolidation measure in the period 2015-16. One-off or temporary solutions, like debt refinancing, which could contribute 0.6 % of GDP in 2015, or lower indexation of wages and pensions (0.3 % of GDP in both years), could only serve to support a set of permanent and sustainable adjustments in the public sector. In view of this, a reform of big entitlement programmes, like the pension system, and of state aid provisions would require special attention.

Box II.3.1: The budget for 2014

The parliament adopted the 2014 state budget on 10 December 2013.

The consolidation measures are split almost evenly on the revenue and expenditure sides. The main adjustment is to come from the increased special VAT rate from 8 % to 10 %, followed by lower subsidies and spending on public sector wages.

Table: Main measures in the budget for 2014

Revenue measures*	Expenditure measures**
VAT, increase in the special VAT rate from 8 % to 10 % and change in the list of products (0.50 % of GDP)	Reduction of public sector wages (marginal 20 % tax on monthly income in the range RSD between 60 000-100 000 and 25 % on income above RSD 100 000) (-0.30 % of GDP)
Fighting the shadow economy (0.25 % of GDP)	Reduction in subsidies to companies (-0.30 % of GDP)
Tobacco excises — fighting the shadow economy (0.15 % of GDP)	Reduction in goods and services (-0.10 % of GDP)
	Refinancing of expensive public debt (-0.02 % of GDP)
Total tax revenues effect (0.90 % of GDP)	Total expenditure effect (-0.70 % of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: PEP 2014

Revised fiscal rules and further improvements in public finance management could support future consolidation efforts. The current set of fiscal rules proved weak and failed to prevent major budget slippages and the accumulation of excessive government debt. In order to strengthen the fiscal adjustment path, a more demanding corrective arm of the rules should be considered that would also delineate responsibilities in case they are not followed. Over the last year there have been important advances in public finance management, like the creation of a single register of public sector employees. An ambitious reform agenda has been put forward in this field, ranging from introducing programme budgeting as of 2015 and streamlining public sector employment, to creating incentives for the restructuring of local public enterprises and making better use of local governments' fiscal

capacities. These reforms have significant potential not only to improve the quality and efficiency of the public sector but, if followed in a rigorous way, to contribute to the much needed fiscal adjustment.

Box II.3.2.: Debt dynamics

Government debt is envisaged to start falling only in the last year of the programme. The effects from inflation are seen as almost completely netted out by interest payments, while real GDP growth slowly gains track in reducing the debt ratio and the primary balance turns to surplus by 2016. Stock-flow adjustments are expected to be adding to the debt in all the programme years, due to nominal dinar depreciation, new state guarantees and assumption of debt of other entities. It will be one of the most important underlying factors for debt dynamics, even if 4.1 % of GDP in privatisation receipts in 2014 are taken into account.

Composition of changes in the debt ratio (% of GDP)					
	2012	2013	2014	2015	2016
Gross debt ratio [1]	60.9	62.7	65.7	68.1	67.9
Change in the ratio	11.1	1.8	3.0	2.4	-0.2
<i>Contributions [2]:</i>					
1. Primary balance	4.4	3.0	2.5	1.6	-0.6
2. 'Snow-ball' effect	-0.7	-3.4	-0.8	-1.7	-1.3
<i>Of which:</i>					
Interest expenditure	2.0	2.6	3.0	2.6	2.9
Growth effect	0.8	-1.1	-0.6	-1.1	-1.3
Inflation effect	-3.5	-4.9	-3.2	-3.2	-3.0
3. Stock-flow adjustment	7.3	2.3	1.4	2.6	1.8

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: PEP 2014, ECFIN calculations

Government debt has entered a danger zone. It may reach around 70 % of GDP this year, higher than foreseen in the programme, and related interest payments are set to top 3 % of GDP. Under the programme's baseline scenario, it will take until 2025 for the government debt to return to the threshold of 45 % of GDP, not counting further increases due to restitution-related debt of up to EUR 2 billion that may be assumed in 2016. In view of the significant fiscal pressures, the authorities' plans to stabilise the debt below 70 % of GDP and to start reducing it from 2016 are optimistic. Despite some inroads to further developing the domestic dinar-denominated market for government securities, government debt is likely to remain highly sensitive to exchange rate dynamics — a major risk for the debt profile. Risks, related to debt servicing, also stem from possible delays of the planned refinancing of debt with high interest payments. Interest rate risks seem manageable, in view of the fact that about three-quarters of the debt is with fixed interest rates.

Public sector losses would continue to be transferred to the government. As show in the *Box* on debt dynamics, stock-flow adjustments in support of the inefficient public sector, like new state guarantees and the assumption of debt of other entities, are among the biggest contributors to increased debt. Highlighting the gravity of the issue, by the end of 2013, more than 70 % of the government-guaranteed debt had already been activated. Therefore, significant further efforts would be required to limit the state's exposure to losses generated by state-owned enterprises

3.4. STRUCTURAL REFORMS

Structural bottlenecks have accumulated over the years, stifling growth and economic development. Economic weaknesses are manifold, ranging from a bloated public sector, to poor infrastructure, a rigid labour market, an unfriendly business environment, informalities and insufficient competition in certain sectors. Little has been done to address these issues since the last PEP and the country is still facing an unchanged and large reform agenda. Constant delays in implementing structural reforms have had a high cost in unemployment, low incomes and increased indebtedness, straining the social fabric and limiting future policy options.

The authorities are well aware of the magnitude of the challenges but still need to follow up on announced policy intentions. The programme's structural reform plans are ambitious, broad-based and address major obstacles to growth. However, like in the previous year, most of the proposed measures are still in their preparatory phase. Their prompt implementation remains of utmost importance and will test the government's commitment and ability to manage the various social and economic costs. In order to enhance the credibility of the reform agenda, the government needs to follow-up though with its plans and ensure their timely implementation.

Developing a viable private sector should top the priority list. Although sweeping reforms are needed in many sectors to revitalise the economy and attract new investments, bold measures to improve the business environment and support private sector development should be adopted with urgency. Announced reductions in administrative and regulatory barriers, in particular those related to construction permits, should be implemented quickly. New legislation to speed up privatisation, increase labour market flexibility and improve the bankruptcy procedure that has been in the pipeline for several months should also be moved ahead, along with further steps to modernise the tax system. Some measures to improve the tax collection system, like the introduction of a single tax return form for the employed and allowing the online submission of tax returns have already been introduced in early 2014. However, a better oversight and reduction of the scope of para-fiscal charges is warranted. This is also acknowledged by the authorities who are proposing to regulate by law all fees collected for the use of public goods.

Completion of the restructuring of state-owned enterprises is long overdue. Some steps in preparing for the final stage of this process have been made but the adoption of the necessary legislative changes was put on hold due to early elections in March. An important milestone should be reached in mid-May 2014, when the protection from forcible collection and bankruptcy that has allowed the survival of many loss-making enterprises, is expected to be removed. Out of the 179 enterprises in restructuring, the procedure has already been completed through liquidation or bankruptcy for 27 of them. However, the remaining enterprises, and another 419 companies form the portfolio of the Privatisation Agency which employ some 100 000 people, are still to be dealt with. If followed through as planned, the process should have an important impact on the economy and the budget over the long run, due to reduced subsidies and improved competitiveness. In the short run, it would also lead to increased unemployment, higher spending on redundancy programmes, and the assumption of past obligations to employees and other creditors.

Significant gains could be reaped in the public sector at large. Some of the big state-owned companies, in particular in infrastructure and utilities, have been a constant source of market distortions via accumulated arrears, bloated employment, failure to collect all their dues, building-up debt, and under-pricing leading to direct and indirect budgetary pressure. However, as recognised in the programme, these companies could also be a potent source of savings and improved efficiency. To this end, there is a need of introducing a hard budget constraint and limiting future state exposure via subsidies and guarantees. A number of measures, aimed at improving corporate governance, have already been put forward. These include the appointment of professional managers, measures of business performance, corporatisation, and increased transparency through financial and business

reporting, the liberalisation of prices, and privatisation. Implementing these proposals, however, has so far proven difficult, preserving opportunities for rent seeking and sapping an important avenue for bringing investments and technologies to key sectors.

The PEP foresees a subsidies reform and a review of all state aid provisions. Such a review would improve the understanding of the efficiency of different forms of aid (subsidies, tax incentives, soft loans and guarantees) and provide important insights to reforms of public enterprises. A targeted and gradual state aid reduction plan should, therefore, be linked to the completion of the restructuring of state-owned enterprises and, together with other reforms, facilitate the creation of a more competitive environment. In addition, the programme is seeking improvements in cost-effectiveness and reduction of subsidies at municipal level and in local utilities.

In line with already adopted strategic documents, the PEP outlines further steps in streamlining and improving the quality of education and health care. A rationalisation of both systems is planned in order to boost their efficiency and better match new demographic realities. Additional state funding is to be channelled to increase the number of students in engineering and incentivise teachers to achieve better results. Introducing school rankings, reviewing programmes, investing in teachers' qualifications, and strengthening regulatory functions in private education are expected to improve the quality of education. The focus in health care is on switching from curative to preventive medicine, reducing non-medical staff and better controlling expenditure via centralised procurement and information system.

The success of reforms hinges to a large extent on creating new jobs and a more dynamic labour market. Therefore, achieving the programme's goal of net new job creation in its last two years is essential for containing social pressures and the already high unemployment. Employment expectations are premised on the projected increase in investment and improvements in the overall business environment, but also on decisive measures to revisit labour legislation, like linking severance payments to the number of working years with the current employer, making it easier to terminate employment, and extending the maximum duration of fixed-term employment. To support these reforms, sufficient funding for redundancy programmes and active labour market measures needs to be provided.

Core public system reforms, like administration and pensions should form the backbone of sustainable fiscal adjustment. An ambitious public administration reform is expected to streamline administration at central and local level, while improving capacities, specifying promotion criteria, harmonising the salary systems, and introducing performance-based remuneration. As of 2015, the programme of wage bill rationalisation is expected to be operational, contributing significantly to the envisaged fiscal consolidation. A proposal for pension reform, based on raising the minimum retirement age for all from 58 to 60 years, a gradual increase in the retirement age for women to 63 years by 2020, introducing penalties for early retirement, and restricting criteria for granting special pensions is also advanced in the programme. Although it is not expected to bring immediate savings, reforming the pension system is indispensable for a sustainable reduction of budget deficits over the medium-to-long term. In view of the aging population, very high levels of pension expenditure (13.7 % of GDP in 2013), significant deficits in the system (5.8 % of GDP) and the high average pension-to-salary ratio, steps to advance the proposed reform should be taken in 2014 as suggested by the programme.

Annex: Overall Assessment of Programme Requirements

The government adopted the programme on 30 December 2013 and submitted it to the European Commission on 24 January 2014. The programme is in line with the medium-term fiscal strategy and the 2014 budget and covers the period 2014-2016. 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.

Macro framework

The programme presents a clear and concise picture of past developments and covers all relevant data at the time of submission. An important revision of national accounts data for 2012 and 2013, in particular regarding investments and exports dynamic, has not been taken into account as it was announced after the adoption of the programme. The macroeconomic framework presented in the PEP is sufficiently comprehensive and coherent. The macroeconomic scenario is plausible and broadly in line with the suggested structural reform measures. Major uncertainties and risks are clearly outlined and recognised by the programme. The authorities have presented an alternative scenario, envisaging a recession in 2014 and a slow recovery thereafter. The programme also includes an alternative fiscal scenario, in case consolidation measures are not implemented. However, it could have benefited from providing a fiscal plan, based on the pessimistic macroeconomic scenario.

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 backing the programme consolidation scenario are well explained, albeit progressively less specified and subject to higher uncertainty. The envisaged adjustment path would require additional efforts and needs to be further strengthened and frontloaded. 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. Further efforts would be needed to ensure ESA '95 compatibility of fiscal data.

Structural reforms

The structural reform framework is coherent and sufficiently comprehensive. However, the authorities would still have to follow-up on announced policy intentions, as little has been done to address them since the last PEP.

4. TURKEY

4.1. EXECUTIVE SUMMARY

The Turkish economy has grown at an average annual rate of 5.1% since 2001 with pronounced cyclical swings. The Pre-Accession Economic Programme (PEP) for 2014-2016 describes how the economy re-accelerated in the first half of 2013 following a slowdown in 2012. This was helped by monetary policy accommodation and a relatively large increase in public spending. In the third quarter, growth started to slow again on a quarter-on-quarter basis as public spending was reined in. Monthly data suggest a further moderate slowdown in the fourth quarter. The Turkish government's official projection for annual GDP growth in 2013 is 3.6%.

The PEP projects a strengthening of economic growth for 2014 and 2015. The programme does not consider that economic activity is likely to extend the slowdown from the second half of 2013 following the recent sell-off in Turkish assets and the related policy response. Since May 2013, Turkey's financial markets and the lira have been under strong downward pressure in the context of the transition to a less accommodative monetary policy in the United States, domestic political crises, and international tensions related to the civil war in neighbouring Syria. By the end of February 2014, the yield on the two-year benchmark government note had risen by about 6 percentage points, the major index on the Istanbul stock exchange had fallen by just above 30%, and the Turkish lira had depreciated by 22% against the euro. The central bank has reacted to market developments by raising policy rates sharply and by intervening heavily in the foreign exchange market. Financial conditions have tightened significantly.

Apart from an impending slowdown, Turkey's economy faces two major macro-economic challenges. On the external side, a large and persistent current account deficit (7.9% of GDP in 2013) makes the economy dependent on equally large capital inflows. Net foreign direct investment covers only a relatively small share of the deficit. Most of the deficit is financed with relatively short term capital flows which are sensitive to changing expectations regarding international yield differentials and risk sentiments. As witnessed in recent years, this tends to result in large exchange rate swings and boom-bust cycles in economic activity. Gross external debt is trending higher, reaching EUR 282 billion (53.1% of GDP) at the end of 2013. Net international reserves amounted to EUR 34.2 billion (6.5% of GDP) at the end of 2013 which is relatively modest considering Turkey's external financing requirements. The vulnerability associated with the external imbalance could be reduced by increasing national saving.

On the internal side, the economy is suffering from persistently high inflation averaging 8.3% over the past ten years. In March 2014, headline inflation registered 8.4%. Although this is a major improvement compared to the early 2000s when inflation was running at annual rates above 50%, high single-digit inflation rates are still problematic in terms of macro-economic stability, resource allocation and re-distributive effects. Inflation expectations regarding the next two years are well above the central bank's 5% medium-term target and have, in fact, increased since last May. Lowering inflation and inflation expectations would require a sustained effort to rein in credit growth which was still running above 30% year-on-year in the first two months of 2014.

The PEP provides an account of the public finances which have shown moderate deficits in recent years, even during periods with strong growth. The data reveal that expenditures have exceeded budgetary limits and been growing well above nominal GDP over the past two years. The rigidity of non-discretionary spending poses a challenge for adjusting the overall fiscal stance to macroeconomic needs. Since fiscal deficits have been relatively modest and nominal GDP growth has been high, the

debt-to-GDP ratio of general government has trended downwards over the past four years to 36.3% of GDP at the end of 2013. Although the sustainability of public debt is currently not in question, a more restrictive fiscal policy stance in cyclically adjusted terms would be appropriate in view of the macroeconomic challenges, in particular the need to increase national saving.

As described in the programme, monetary policy continues to be conducted within an unconventional framework in which inflation and macro-financial stability are the main targets. The framework is constantly being developed and refined and remains very complex. There is ample room for improving the transparency and predictability of monetary policy. The monetary policy decisions of 28 January 2014 may be a step towards a more conventional monetary policy. In view of the persistent gap between actual and targeted inflation, the monetary policy stance has been too accommodative. In light of this, the tightening in January 2014 was appropriate.

Regarding structural reforms, the PEP describes recent and ongoing measures in a broad range of areas. However, the specific measures are not presented within a broad strategic framework for economic development which would also address the need to reduce macro-economic imbalances. There are no references to the role of productivity-enhancing reforms in improving the international competitiveness and to the way in which competition-enhancing reforms could help reducing inflation. Initiatives to develop the investment climate are not presented in any detail although this should be a reform priority in view of Turkey's need to attract a sustained inflow of direct and long-term portfolio investments from abroad.

4.2. ECONOMIC OUTLOOK AND RISKS

The macro-economic scenario is an optimistic combination of faster growth, driven by domestic demand, and reductions of macro-economic imbalances. The PEP projects annual GDP growth of 4.0% in 2014 and 5% in the following two years. Assuming potential output growth of around 4.3%, this growth path is estimated to close the output gap by 2016 from -1.2% in 2013. Annual average inflation is projected to decline gradually from 7.5% in 2013 to 5% in 2016. The scenario expects the current account deficit to narrow to 5.5% of GDP by 2016. The unemployment rate is projected to decline moderately to 8.9%.

The value of the macroeconomic scenario is seriously weakened by excluding the impact of recent market and policy developments. The PEP's macro-economic scenario is identical to the projections in Turkey's Medium Term Programme (MTP) 2014–2016 which was adopted by the government last September 2013. The projections have not been adjusted to take into account the significant developments in financial markets and related policy measures in the half-year period between the finalisation of the MTP and the submission of the PEP. The stated reason is that these developments do not necessarily change the medium term framework set in the MTP. This is, however, an unsatisfactory explanation in view of the likely impact of these developments (the depreciation of the currency, the rise in market interest rates, the decline in stock prices, the tightening of monetary policy, credit-curbing macro-prudential measures) on the main macro-economic variables. As a consequence, the PEP's projections appear more like outdated policy targets than as a realistic forecast.

Recent forecasts of the Turkish economy differ significantly from the PEP's macro-economic framework. The change in the Consensus Forecast between September 2013 and February 2014 reflects the general view about the impact of recent developments on some main economic indicators. For 2014, GDP growth has been revised down from 3.9% to 2.6%, inflation has been revised up from 6.6% to 7.6% and the current account deficit has been revised down from 8.4% of GDP to 6.7%. The revisions in the Commission's forecast between the autumn 2013 and February 2014 go in the same

direction. The Commission's latest forecast is much less sanguine than the PEP regarding growth and inflation, but expects a stronger improvement of the current account.

Projected GDP growth is on the optimistic side. The PEP envisages annual economic growth to increase from 3.6% in 2013 to 4% in 2014 and further to 5% in 2015 and 2016. This projection may have had plausibility before the downward pressure on Turkey's financial markets and the lira started in May 2013. It has, however, become increasingly unrealistic in parallel with market and policy developments in the nine-month period to February 2014. There has been a 600 basis-point rise to about 11% in the yield of the two-year benchmark government note, a 30% drop in the major index on the Istanbul stock exchange, and a 22% depreciation of the Turkish lira against the euro. On the policy front, the central bank moved to a less accommodative monetary policy last summer and then tightened monetary policy decisively in January 2014 which will lower domestic demand significantly. The pass-through of the lira depreciation to domestic prices will reduce both private and public consumption in real terms. Consumer spending will also be hit by higher interest rates, recent macro-prudential measures to lower household borrowing, some indirect tax hikes, a negative wealth effect, and declining confidence. Business investment will be curbed by higher interest rates, by higher funding costs due the stock market correction, and by deteriorating balance sheets for companies with debt in foreign exchange.

Table II.4.1:

Comparison of macroeconomic developments and forecasts

	2012		2013		2014		2015		2016	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	2.2	2.2	3.8	3.6	2.5	4.0	3.0	5.0	n.a.	5.0
<i>Contributions:</i>										
- Final domestic demand	-0.5	-0.5	4.2	4.0	0.7	3.4	1.8	5.0	n.a.	4.9
- Change in inventories	-1.4	-1.4	1.1	1.1	0.2	-0.1	-0.2	0.0	n.a.	0.1
- External balance of goods and services	4.1	4.1	-1.6	-1.6	1.6	0.8	1.4	0.0	n.a.	0.1
Employment (% change)	2.9	2.9	3.0	3.5	2.0	2.2	2.7	2.5	n.a.	2.3
Unemployment rate (%)	9.2	9.2	9.8	9.5	10.5	9.4	10.4	9.2	n.a.	8.9
GDP deflator (% change)	6.8	6.8	5.4	6.3	7.4	6.0	8.1	5.0	n.a.	5.3
CPI inflation (%)	8.9	8.9	7.5	7.5	8.7	5.4	7.4	5.2	n.a.	5.0
Current account balance (% of GDP)	-6.1	-6.1	-7.8	-7.1	-6.5	-6.4	-4.4	-5.9	n.a.	-5.5
General government balance (% of GDP)	-1.0	-1.0	-1.6	-1.0	-2.9	-1.1	-2.5	-0.8	n.a.	-0.5
Government gross debt (% of GDP)	36.2	36.2	36.0	35.0	36.7	33.0	36.2	31.0	n.a.	30.0

Sources: Pre-Accession Economic Programme (PEP) 2014, Commission Winter 2014 forecast (COM)

The reduction of domestic demand will be accompanied by expansionary effects from the lira's 15.1% real effective depreciation between March 2013 and March 2014. The lira's depreciation will improve the international price competitiveness of Turkish goods and services, thereby re-directing economic activity towards exports and import-substituting output. This, combined with the recovery in Turkey's export markets, will partly offset lower domestic demand growth and lead to some rebalancing of the economy. The Commission expects therefore that growth will recover to 3.0% in 2015 from 2.5% in 2014. Considering the domestic political uncertainty and the possibility of a further sell-off in Turkish financial assets in context of a normalisation of monetary conditions in developed markets, the risks to this growth projection are biased to the downside.

The PEP's near-term inflation scenario is unlikely to be realised. The projected decline in annual average inflation from 7.5% in 2013 to 5.4% in 2014 is practically unattainable. Year-on-year inflation registered 7.4% in December 2013 and has subsequently risen to 8.4% in March 2014. The lagged effects from the recent lira depreciation are likely to push up headline inflation further in

coming months. The central bank has recently raised the mid-point for expected inflation at year-end to 7.6%, but even this seems optimistic at the current juncture. The Commission forecasts annual average inflation of 8.7% in 2014. Whether the central bank will achieve its 5% inflation target by the end of 2015 is doubtful in view of the recent deterioration in inflation expectations. The target also appears inconsistent with the PEP's projection of 5% GDP growth in 2015.

The current account is likely to improve more than projected in the PEP. The current account deficit corresponded to 7.9% in 2013 according to data released in March 2014. The PEP expected a deficit of 7.1% of GDP and projected a gradual decline over the following three years to 5.5% in 2016. However, if GDP accelerated as projected in the PEP, it is likely that the current account would worsen considering the historical correlation between the two variables. Apart from that, the PEP's current account projection, like the GDP and inflation projections, has been made outdated by the recent developments. In view of the lira's real depreciation in the twelve-month period to March 2014 and the related adjustment to lower and more export-oriented GDP growth, the current account is now likely to improve faster. The Commission expects the deficit to narrow to 4.4% of GDP by 2015 compared to 5.9% in the PEP.

Turkey remains vulnerable to a slowdown of capital inflows. Rather implausibly, the PEP portrays Turkey as a safe haven for capital flows and expects the country to be less affected than other developing countries from a worsening in global liquidity conditions. It expects that the country's high external financing needs will be met without any difficulty. The Commission assesses that this will require a favourable investment climate which, in turn, depends on the strengthening of the rule of law, separation of powers, political pluralism and property rights. In 2013, only a relatively small share (14.7%) of the current account deficit was financed with net foreign direct investments. Net portfolio investments covered twice as much (28.3%) and most of the remainder (47.0%) was met by banks' foreign borrowing. Including refinancing of existing debt, external financing requirements are estimated to total about a quarter of GDP per year. Turkey's external debt is predominantly in foreign currency (93% in 2012). Gross external debt increased from 42.6% of GDP at the end of 2012 to 53.1% of GDP⁽¹⁾ at the end of 2013 due to the current account deficit and valuation effects. Turkey's net international investment position corresponded to 53.3% of GDP at the end of 2013. Gross foreign exchange reserves (EUR 81 billion, or 15.4% of GDP, at the end of 2013) have been bolstered in recent years by the central bank encouraging banks to meet reserve requirements with foreign exchange deposits. However, only net foreign exchange reserves are available to meet external financing needs and for exchange market interventions. Net international reserves (including gold, SDRs, and the IMF quota) amounted to EUR 34.2 billion (6.5% of GDP) at the end of 2013 which would only be a small cushion under adverse global liquidity conditions in view of the total size of external financing requirements.

The banking sector has remained relatively resilient, but will be facing a challenging environment. Macro-prudential measures were introduced last October to rein in household borrowing. Credit growth has remained above 30% on a year-on-year basis, but with a noticeable slowing on a sequential basis in the first quarter of 2014. The banks' loan-to-asset ratio has risen above 60% and the loan-to-deposit ratio above 110%. The capital adequacy ratio has trended downwards in recent years, falling from 19.9% at the end of 2012 to 15.3% at the end of 2013. The share of non-performing loans in total loans has remained stable at around 2.8%. Going forward, there is a risk that the banking sector's asset quality will decline in conjunction with lower GDP growth and higher funding costs in the context of tightening global liquidity. The loan servicing capacity of parts of the business sector may become strained, particularly regarding unhedged foreign-currency denominated loans following the recent lira depreciation. Net foreign exchange liabilities of the non-financial corporate sector corresponded to around 24% of GDP at the end of 2013. The banking

⁽¹⁾ Official gross debt stock (in USD) converted into TRY at the exchange rate at the end of the year and expressed as a ratio of nominal GDP in the same year.

sector's net profits rose 5.1% in 2013, but there is a risk that profitability will suffer in conjunction with slower economic growth.

4.3. PUBLIC FINANCE

In contrast to the preceding year, the central government's budget deficit was lower than originally planned in 2013. In 2012, the central government's original deficit target of -1.5% of GDP was overshot on the downside with an outturn of -2.1%. For 2013, the original budget operated with an unambitious deficit target of -2.2% of GDP, but this was revised to -1.2% last October and this is estimated to have been realised. Expenditures increased by 12.7% compared to 2012, clearly above nominal GDP growth (an estimated 9.4%) and with some significant budgetary overruns, not least on capital spending. Revenues increased by a strong 17.1% year-on-year. Higher-than-budgeted revenues were mainly due to changes in indirect taxation and social security premiums, higher-than-expected privatisation and dividend receipts, and one-off factors like the payment of VAT arrears by state-owned enterprises. According to the PEP, the fiscal deficit of general government (excl. privatisation revenues) increased from 1.5% of GDP in 2012 to 1.6% in 2013. (The PEP's general government data are not fully aligned with the ESA95 standard). According to another measure of the general government deficit, which is also presented in the PEP and excludes both privatisation receipts and one-off items, the deficit widened from 2.2% of GDP in 2012 to 2.4% in 2013. Last year's PEP had projected a narrowing of this deficit by 0.2 percentage points. It is therefore fair to conclude that, even when allowing for a small negative output gap, Turkey's expansionary fiscal stance became slightly more pronounced in 2013 in spite of the decline in the "headline" central government deficit and in contrast to last year's projection.

The fiscal deficit of central government is likely to increase more than projected in 2014. The PEP and the central government's 2014 budget project plausibly that the central government's revenues will grow at a much slower rate than in 2013 when revenue growth was boosted by special factors. Revenues as a share of GDP are projected to fall back to the level of 2012. But this projection is still based on a macro-economic scenario with 4.0% GDP growth. Because of the likely economic slowdown, revenue growth can be expected to fall short of budget. On the expenditure side, the budget projects that spending growth will be reined in to less than nominal GDP growth. This would reduce the ratio of public expenditures to GDP by 0.7 percentage points below the level in 2013 and by 0.2 percentage points below the level in 2012. This will require a level of spending discipline which has not been in evidence in recent years when expenditures have increased faster than nominal GDP. Furthermore, expenditures in 2014 are likely to be pushed above budget ceilings by rising transfer payments in the context of an economic slowdown. Overall, it seems likely that this year's deficit target of 1.9% of GDP for central government will be exceeded significantly.

The projected path of fiscal consolidation may not meet the macro-economic needs. The PEP projects that the fiscal deficit of general government (excl. privatisation revenues) will increase by 0.1 percentage point to 1.7% of GDP in 2014 before declining by 0.5 percentage points in each of the following two years. According to the alternative deficit measure, which also excludes one-off items, the deficit will be reduced by about half a percentage point per year from 2.4% of GDP in 2013 to 0.8% in 2016 when the negative output gap is projected to be essentially closed. The projection is not underpinned with details about the measures which could ensure that expenditures will rise less than nominal GDP over the programme period. The Commission's most recent forecast, based on a less sanguine macro-economic scenario than the PEP, expects the general government deficit to widen to 2.9% of GDP in 2014 before receding to 2.5% in 2016. If the PEP's fiscal scenario for 2014-2016 was realised, it would represent a moderate and gradual tightening of the current expansionary fiscal policy stance. However, in terms of the need to achieve a significant increase of overall national saving, it is questionable whether the projected fiscal tightening is sufficient.

Table II.4.2:
Composition of the budgetary adjustment (% of GDP)

	2012	2013	2014	2015	2016	Change: 2013-16
Revenues	37.8	39.7	38.4	38.1	37.7	-2.0
- Taxes and social security contributions	29.6	31.5	31.1	31.0	30.7	-0.8
- Other (residual)	8.2	8.2	7.3	7.1	7.0	-1.2
Expenditure	38.9	40.8	39.6	39.0	38.2	-2.6
- Primary expenditure	35.4	37.4	36.5	36.1	35.7	-1.7
<i>of which:</i>						
Gross fixed capital formation	3.5	4.0	3.6	3.8	3.7	-0.3
Consumption	17.5	18.2	18.1	17.6	17.4	-0.8
Social transfers & subsidies	8.5	8.8	8.8	8.7	8.5	-0.3
Other (residual)	5.9	6.4	6.0	6.0	6.1	-0.3
- Interest payments	3.5	3.4	3.1	2.9	2.5	-0.9
Budget balance	-1.0	-1.0	-1.1	-0.8	-0.5	0.5
Structural balance	-2.1	-2.3	-1.6	-1.2	-0.8	1.5
Primary balance	2.5	2.3	2.0	2.1	2.0	-0.3
Gross debt level	36.2	35.0	33.0	31.0	30.0	-5.0

Sources: Pre-Accession Economic Programme (PEP) 2014, ECFIN calculations, differences due to rounding

The debt-to-GDP ratio has been raised by exchange rate developments. The debt of general government, defined in accordance with ESA95, corresponded to 36.2% of GDP at the end of 2012. The PEP projects a debt-to-GDP ratio of 35.0% for the end of 2013. However, this projection, which stems from the MTP, does not take account of the lira's depreciation in late 2013. This has increased the value of the debt in lira terms since close to 30% of the debt stock is denominated in foreign currencies. It is now established that the debt ratio at the end of 2013 amounted to 36.3% of GDP. For the programme period, the PEP projects a 5 percentage point decline in the debt ratio. If economic growth is significantly lower in 2014 and 2015 than projected in the PEP and fiscal deficits develop as projected by the Commission, the debt ratio will stay around the current level rather than decline.

4.4. STRUCTURAL REFORMS

The PEP's section on structural reforms covers a broad range of sectors and areas which are targets for public policy. However, the presentation is heterogeneous in the sense that some policy areas are described in appropriate detail (e.g. labour and capital markets) while the coverage of other areas is rudimentary (e.g. privatisation, energy, transport). There is no attempt to present specific policy measures within a broader strategic framework for economic development which also addresses the need to reduce macro-economic imbalances. This is all the more surprising since Turkey's Tenth Development Plan (2014-2018) provides a reasonable basis for such a description. Structural impediments to increasing potential growth are not identified. There are no references to the role of productivity-enhancing reforms in improving the international competitiveness and to the way in which competition-enhancing reforms could help reducing inflation. This makes the section on structural reforms an eclectic catalogue of specific policy measure most of which have already been implemented. Only some of the sub-sections present parts of a forward-looking programme. The PEP would have benefitted from a prioritisation of key structural reforms, including timetables for implementation.

The programme makes little mention of measures to improve the investment environment. Developing a business-friendly investment climate is crucially important for attracting a sustained

inflow of direct and long-term portfolio investments from abroad. Such inflows are needed to lower Turkey's vulnerability to erratic short-term capital movements and to increase potential growth. The PEP refers briefly to existing and prospective action plans to improve the business and investment climate, but no details are provided on this important part of any structural reform agenda.

More emphasis is put on labour market developments and their link to educational reforms.

Ongoing active labour market policies are described regarding their aim (improving the qualifications of low-skilled workers), their content (e.g. the number of people receiving training) and their budgetary costs. Programmes on IT training, vocational and technical education, and life-long learning are covered, including their forward-oriented dimension. A range of measures are presented which are intended to make working conditions more flexible over the coming years. These reforms, if implemented as indicated, would represent major advances towards tackling the very low female labour participation rate and the high level of informal working arrangements which is hampering productivity.

Annex: Overall Assessment of Programme requirements

The Pre-Accession Economic Programme 2014-2016 (PEP) was adopted by the government's High Planning Council in its Decision No. 2014/1 and submitted to the Commission informally on 27 February 2014 and formally on 6 March 2014, i.e. significantly later than requested (31 January 2014 at the latest). The PEP is in line with the government's most recent Medium Term Programme (2014-2016) and the Tenth Development Plan (2014-2018). It makes few references to the EU accession process and does not respond to the call to progressively adapt to the EU's strengthened economic governance by including an assessment of the sustainability of the external position and a description of the main structural obstacles to growth. Moreover, the PEP does not report on measures taken to implement the relevant conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the candidate countries on 9 July 2013.

Macro framework

The programme's medium-term projections are rather optimistic regarding growth and inflation. Some key challenges are not properly assessed, particularly the sustainability of the current account deficit and the persistence of relatively high inflation. The framework is drawn from the most recent Medium Term Programme which was prepared in mid-2013 and released in October 2013. In view of the significance of market and policy developments between summer 2013 and January 2014, the lack of updating seriously undermines the validity of the PEP's macro-economic framework.

Fiscal framework

Efforts are required to improve fiscal data at general government level on a unified accounting basis according to ESA/international standards. It is difficult to make an in-depth assessment of Turkey's public finance situation in the absence of regular and consolidated general government budget reports. The general government data provided in the PEP differ significantly from other sources, including 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.

The 2014 PEP does not describe budget execution developments in 2013, nor does it identify and explain the measures underlying the 2014-2016 fiscal strategy. These are shortcomings which complicate any assessment of Turkey's fiscal situation and policy framework. Future programmes would benefit from more complete data and from a long-term analysis of public finance sustainability to gain an understanding of the main fiscal challenges in the future, in particular those stemming from demographic and labour market developments.

Structural reforms

The programme presents a wide range of measures relating to the enterprise and financial sector, labour market, agriculture, public administration, regional development, health and social security, R&D and innovation, ICT, transportation, and energy. The presentation is mainly backward looking and with a strong emphasis on harmonisation with EU requirements. The programme does not identify bottlenecks to growth as requested in the Commission's outline. It also does not present the various reform measures within a strategic framework for economic development over the medium term.

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