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2014 Economic and Fiscal Programmes of Albania and Bosnia and Herzegovina: The Commission's country assessments

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Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Unit Communication
B-1049 Brussels
Belgium
E-mail: ecfin-info@ec.europa.eu

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2014 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania and Bosnia and Herzegovina).

In 2001, a regular economic fiscal surveillance procedure was established for candidate countries. It aims to prepare these countries for participation in the multilateral surveillance and economic policy co-ordination procedures of the EU's Economic and Monetary Union. The Pre-Accession Economic Programmes (PEPs) of candidate countries are part of this procedure. Since they began in 2001, the PEPs have evolved into an important platform for authorities in these countries to develop and communicate appropriate medium-term economic, fiscal and structural policies that are consistent with their EU membership aspirations.

For this reason, a similar exercise was started in 2007 with the potential candidate countries. These countries, which were promised the prospect of joining the EU when they are ready but are not yet recognised as candidates, are required to submit EFPs outlining a medium-term policy framework, including public finance objectives and structural reform priorities. The programmes are also an opportunity to help these countries develop the institutional and analytical capacity necessary to participate in the EU's economic governance framework, particularly in the areas of multilateral surveillance and economic policy coordination.

Albania and Bosnia and Herzegovina submitted their EFPs for the period 2014-2016 at the end of January 2014. Both programmes have been made public([1]).

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 András Tari (Albania) and Mariya Hake (Bosnia and Herzegovina).

The programmes and their assessments by the Commission staff were discussed during an experts' meeting on 23 May 2014 in Brussels, with experts from Albania, EU Member States, the European Central Bank and the Commission. Experts from Bosnia and Herzegovina were absent because of the extraordinary circumstances following severe floods in the country.

Comments would be gratefully received and should be sent to:

Directorate-General for Economic and Financial Affairs
Economies of candidate and pre-candidate countries
Carole Garnier
European Commission
B-1049 Brussels

or by e-mail to: carole.garnier@ec.europa.eu

([1]) Albania:
http://www.financa.gov.al/files/userfiles/Programimi_EkonomikoFiskal/Programi_Ekonomik_e_Fiskal/EFP_2014_english_FINAL.pdf;

Bosnia and Herzegovina:
http://www.dei.gov.ba/dei/media_servis/vijesti/default.aspx?id=13158&langTag=bs-BA.

Part I

Overview

1. OVERVIEW OF THE 2014 PROGRAMMES

The programmes of Albania and Bosnia and Herzegovina share some common features and objectives. They both aim to revive growth and consolidate public finances and lay out reforms to achieve these intentions.

In 2013 net exports helped sustain modest growth in both countries. Energy exports (crude oil in Albania, electricity in Bosnia and Herzegovina) were particularly strong, while weak domestic demand subdued imports. In Albania, new rounds of monetary stimulus could not prevent weak consumption and especially private investment spending from dragging down growth to an estimated 0.4 %, the slowest pace since 1997. Bosnia and Herzegovina fared somewhat better, overcoming a recession in 2012 with 1.5 % growth in 2013.

In the medium term, both programmes expect a gradual firming of growth. Domestic demand is forecast to strengthen and take over as the main growth engine in both countries. In Albania, this assumption is supported by the new government's intention to clear large outstanding public arrears within three years, financed by loans from the IMF and the World Bank. This is expected to improve private sector liquidity and help restore confidence. In both countries, investment should also get a boost from some large energy projects already in the pipeline.

Table I.1.1:

Economic and Fiscal Programmes 2014
Key indicators

	2010	2011	2012	2013	2014	2015	2016
Growth (GDP, real, annual % change)							
Albania	3.8	3.1	1.3	0.7	2.1	3.3	4.2
Bosnia and Herzegovina	0.8	1.0	-0.9	1.5	2.3	2.8	3.5
Unemployment rate (%, LFS)							
Albania	13.7	13.4	14.4	16.9	16.2	15.5	14.3
Bosnia and Herzegovina	27.2	27.6	28.0	27.5	27.5	27.1	26.4
Current account balance (% of GDP)							
Albania	-11.5	-13.0	-10.7	-10.0	-8.2	-7.5	-7.3
Bosnia and Herzegovina	-6.1	-9.7	-9.2	-6.7	-7.2	-7.8	-9.2
Inflation (CPI, annual % change)							
Albania	3.6	3.5	2.0	1.9	2.7	2.8	3.0
Bosnia and Herzegovina	2.1	3.7	2.1	0.3	1.5	1.6	1.5

Source: Economic and Fiscal Programmes (EFP) 2014 for 2012-2016, CCEQ for 2010 and 2011.

…but various downside risks are present. A sustained economic recovery will require a revival of lending, which has been under stress in both countries. Although domestic banks are well-capitalised and liquid, a high share of bad loans has made them reluctant to extend new loans. Despite earlier efforts in both countries to resolve non-performing loans (NPLs), further action seems necessary, especially in Albania where as many as 24 % of loans are classified as non-performing. A strong investment revival could also be constrained by glaring weaknesses in the business environment, such as uncertain property rights, onerous and unclear regulations, as well as deficiencies in contract enforcement and the rule of law. The disruption caused by the recent severe floods in Bosnia and Herzegovina will also affect the near-term outlook. Finally, renewed external headwinds could emerge if the economic situation in the EU deteriorates, as it is the main trade and investment partner of both countries.

External imbalances remain a source of macroeconomic vulnerability. Despite recent improvements in export performance, the trade deficit is high in both countries, reflecting a narrow production base and weak competitiveness. Remittances, which used to be an important source of financing for this deficit, have been diminishing, particularly in Albania. This calls for a strong focus on attracting productive FDI, which, apart from financing the current account deficit in the present, has the potential to boost productivity and diversify the export base in the future. Both countries have large untapped potential in some sectors, such as tourism, that could be better exploited by improving the investment climate. In Albania, privatisation is well advanced, which highlights the need to generate greenfield investments. In Bosnia and Herzegovina, improving the efficiency of state-owned enterprises, including through privatisation, would also greatly support private sector development.

Improved growth prospects are seen underpinning a process of fiscal consolidation, but the underlying measures are often unclear. In Albania, persistent fiscal imbalances and a string of missed deficit targets have led public debt to rise to levels that are very high by regional standards, and the large short-term component of this debt leads to heightened rollover risks. In Bosnia and Herzegovina, the deficit and debt levels are more moderate, but debt servicing costs are rising, crowding out productive spending. Apart from concessional loans from foreign donors, both countries rely on the domestic debt market which, to a large extent, means commercial banks. Such a strong link between banks and sovereigns could lead to market saturation and creates vulnerabilities on both sides. Additional fiscal risks stem from the energy sector in Albania and the pension system in both Albania and Bosnia and Herzegovina. Against this background, both countries intend to consolidate public finances and reduce the level of debt. Albania has taken steps to increase revenues by raising several taxes in the 2014 budget, but fiscal consolidation in the following years depends mainly on economic growth as well as on efforts to improve tax collection. Bosnia and Herzegovina intends to implement significant cuts in public spending, but the details remain vague. Both countries face the challenge of carrying out budget adjustments while preserving room for growth-friendly spending on investment and education.

Table I.1.2:

Economic and Fiscal Programmes 2014
Fiscal indicators

	2010	2011	2012	2013	2014	2015	2016
Total revenue (% of GDP)**							
Albania	26.2	25.5	24.9	24.2	25.7	26.0	26.5
Bosnia and Herzegovina	37.3	40.0	41.7	42.6	40.0	38.2	37.2
Total expenditure (% of GDP)**							
Albania	29.3	29.0	28.4	29.0	32.2	30.8	29.9
Bosnia and Herzegovina	39.4	40.7	43.5	43.6	41.6	40.2	37.8
Government balance (% of GDP) *							
Albania	-3.1	-3.6	-3.5	-4.8	-6.5	-4.8	-3.4
Bosnia and Herzegovina	-2.0	-0.7	-1.9	-1.0	-1.6	-2.0	-0.6
Government gross debt (% of GDP) *							
Albania	58.5	60.3	62.5	70.5	72.1	71.7	69.2
Bosnia and Herzegovina	32.9	35.5	37.6	37.0	37.6	34.7	30.7

* General government, national acc. Standards
** 2011 data from EFP 2013, 2010 data from EFP 2012.

Source: Economic and Fiscal Programmes (EFP) 2014 for 2012-2016

Labour markets remain in dire straits. The weak economy has led the unemployment rate to rise to more than 17 % in Albania and stands at 28 % in Bosnia and Herzegovina. The high headline rates are compounded by the prevalence of long-term as well as youth unemployment. Moreover, participation rates remain low and informal employment is widespread in both countries. Generating job-rich growth and improving the quality of education and training to address skills mismatches therefore remain major challenges.

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

Throughout the crisis that heavily affected its main EU trading partners and spilled over through trade, remittances and investment links, Albania has managed to avoid recession though economic growth has slowed. The external turmoil, however, has increasingly exposed domestic weaknesses and in 2013 growth effectively ground to a halt as even a large fiscal stimulus before the June elections and good export performance were barely enough to keep the economy above water.

Persistent fiscal imbalances in the past have led public debt to build up to well over 60 % of GDP. Substantial weaknesses in revenue collection and public finance management have caused large government arrears, such as unpaid bills and delayed tax refunds, to accumulate, sapping liquidity and confidence in the economy. Along with election-related uncertainty, this has caused private consumption and investment to be sluggish, dragging down economic growth.

The banking sector, while fundamentally stable and reliant mainly on domestic deposits, has also been affected by the slowdown. Non-performing loans (NPLs) have surged as a result of the knock-on effect of the government's unpaid bills as well as the overextension of credit in some sectors particularly hit by the crisis. As a consequence, lending growth has slowed and even turned negative recently, further weakening domestic demand and creating a negative feedback loop.

With inflation at the lower end of the central bank's 2 %-4 % target range due to the negative output gap as well as low imported inflation and well-anchored inflation expectations, the central bank had room for stimulus and cut the policy rate repeatedly down to a record low of 2.5 %. The high risk aversion of banks and weak credit demand, however, have limited the impact of these rate cuts on the economy. At the same time, the exchange rate has remained stable, thanks also to the strength of exports. Net exports have recently been the main driver of growth, partly on the back of a substantial rise in goods exports as crude oil sales surged, but mostly because weak domestic demand has depressed imports. However, the trade deficit and thus the current account shortfall remain substantial.

With little room for further fiscal or monetary stimulus, Albania intends to break the gridlock by seeking IMF and World Bank support for a bold arrears clearance programme that aims at a front-loaded repayment of these obligations, worth 5.3% of GDP, over 2014-2016. This could improve private sector liquidity, help lower NPLs and substantially boost confidence, thus re-launching private investment and consumption, which will be crucial for the recovery to take hold. GDP growth is forecast to accelerate from 0.4 % in 2013 to 4.2 % in 2016, but downside risks remain, in particular as fiscal consolidation needs and the forecast low inflow of remittances will provide little support to domestic demand, while subdued growth in the main foreign markets may dampen export growth prospects.

Albania is confronting its fiscal challenges by raising a number of taxes and eliminating exemptions, in an attempt to reverse the declining trend in the revenue-to-GDP ratio. Budget consolidation, especially in the later years of the programme, also hinges on the expected rebound in growth and thus faces downside risks. Settling public arrears further pushes up debt, which is expected to peak at 72.1 % of GDP in 2014, and the preponderance of short-term debt, which is mainly held by domestic banks, will continue to create significant rollover risks. While there are no immediate plans to re-establish a statutory debt ceiling following the breach and abolition of the 60 % limit in 2012, the IMF-WB programme is expected to act as an anchor for a much-needed gradual but sustained consolidation.

The EFP projects the still large external imbalances to narrow further, as rising exports of goods and services are expected to be only partly offset by a pick-up in imports. However, as from 2015-2016, imports could gather speed more than forecast along with stronger investments. FDI inflows, boosted by some large energy projects already in the pipeline, are expected to remain sizeable and should finance most of the current account deficit.

Attracting foreign direct investments is not only crucial for the balance of payments but also for transferring knowledge, boosting productivity and diversifying Albania's rather narrow production and export base, a source of vulnerability to external shocks. With limited potential for further privatisations, emphasis should be placed on attracting greenfield investments by improving the business environment and tackling long-standing structural impediments to growth. The main challenges include strengthening the legal and regulatory framework, including property rights; combating corruption and the informal economy; addressing the structural problems of the energy sector and the pension system; and improving the skills of the labour force through better education and training. Addressing these issues is crucial to stimulate long-term growth and create employment, thereby reducing the high jobless rate that is exacerbated by the prevalence of long-term as well as youth unemployment.

1.2. ECONOMIC OUTLOOK AND RISKS

The EFP projects a gradual recovery alongside a rebalancing from net exports to private investment and consumption. The programme's medium term scenario assumes a path of steady improvement with growth rates of 2.1 % in 2014, 3.3 % in 2015 and 4.2 % in 2016. Over the past two years, net exports contributed the most to GDP growth, although this was driven more by a cyclically driven fall in imports than exports, whose growth was modest at best. In 2014 the revival of private domestic demand is projected to remain too weak to support the recovery, which will instead have to rely on a continuing positive impact of net exports. In the last two years of the programme, growth is seen to be firm on the back of strong consumption and private investment, with the contribution of net exports receding and real government spending contracting due to fiscal consolidation.

Table II.1.1:

Macroeconomic developments and forecasts

	2012	2013	2014	2015	2016
Real GDP (% change)	1.3	0.7	2.1	3.3	4.2
Contributions:					
- Final domestic demand	-2.5	-1.5	0.1	2.5	3.9
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	3.8	2.2	2.0	0.8	0.3
Employment (% change)	0.0	0.0	0.0	0.0	0.0
Unemployment rate (%)	13.1	13.0	12.8	12.6	12.5
GDP deflator (% change)	2.1	1.7	2.3	2.5	2.7
CPI inflation (%)	2.0	1.9	2.7	2.8	3.0
Current account balance (% of GDP)	-10.7	-10.0	-8.2	-7.5	-7.3

Sources: Economic and Fiscal Programme (EFP) 2014

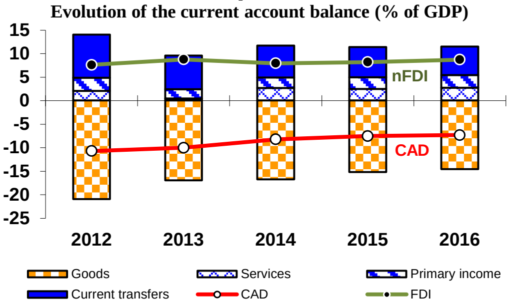
Growth in the short term should be supported by a bold programme to tackle arrears, backed by the IMF and the World Bank, but downside risks remain. The front-loaded payment of accumulated government liabilities, worth as much as 5.3% of GDP, over three years is expected to lift growth by injecting liquidity into companies. This should help unlock the flow of credit to the economy by reducing NPLs and improving banks' balance sheets. Tackling this long-standing issue should also boost business confidence and thus contribute to a turnaround in private investment, which has been the biggest drag on growth in recent years. Seen in this light, improved economic prospects are in order, but the magnitude and composition of the expected growth profile, are subject to non-trivial risks, especially in the later years of the programme. The need for fiscal adjustment and the expected flat remittances inflow will provide little boost to disposable income. Moreover, the 50 % hike in corporate income tax might jeopardise the strong rebound in private investment that has been forecast, unless counterbalanced by reforms to make tax collection less invasive and arbitrary. In any case, stronger investment activity would need to be supported, apart from the confidence-boosting effect of the arrears clearance and of the involvement of the IMF and the World Bank, by further substantial improvements in the business environment. Finally, the revival of both consumption and investment hinges on efforts aimed at restarting lending finally bearing fruit.

With the gradual closing of the output gap, inflation is expected to move closer towards the middle of the central bank's target range of 2 %-4 %. Bank of Albania's inflation targeting regime has served the country well by anchoring expectations and ensuring stable low inflation. The weak cyclical position of the economy and the resulting deceleration in inflation prompted the central bank to engage in monetary stimulus by embarking on a series of cuts in the policy rate, but the pass-through to the economy has so far been limited due to banks' reluctance to increase lending and low credit demand. A hike in excise duties and fuel taxes is expected to lead to a one-off 0.6-1 percentage point increase in the headline inflation rate in 2014, but a forecast stable exchange rate vis-à-vis the euro (which has been remarkably steady recently) and assumed low imported inflation, together with the still weak economy, will mitigate the effects. Overall, it is reasonable to expect, in line with the EFP's projections, that the inflation will remain within the targeted range throughout the programme.

External imbalances have narrowed since their peak in 2008 but remain large. Albania's current account deficit is sizeable at around 10 % of GDP but declined substantially between 2008 and 2012, although it increased again slightly in 2013. Both cyclical and structural factors have been at play to shape the evolution of the deficit. The merchandise trade deficit in particular has declined markedly, thanks to a 50 % rise in goods exports between 2010 and 2013, driven mostly by increased crude oil production. In the process, Albania has managed to diversify somewhat its clients base away from Italy (notably to Spain, Turkey and Kosovo), although Italy's share remains dominant. At the same time, the traditional surplus in the services account has practically disappeared of late, mainly due to weak tourism, whose potential is clearly held back by structural impediments such as weak property rights. Overall, trade adjustment has come in 2012-2013 not only from growth in exports, but to a large extent also from subdued imports amid the weak cyclical position of the economy. Remittances from migrant workers, which traditionally offset a large part of the trade deficit, accelerated their decline in 2013 and fell to 5 % of GDP as opposed to 9 % in 2009. Their lower level now seems entrenched and might reflect, apart from a weak economy in Greece and Italy, the two major destination countries, a structural change in terms of migrant workers' loosening links with their home country.

The EFP optimistically projects the current account gap to close further. Potential for further increases in crude oil exports as well as an expected pick-up in foreign sales of other traditional products, textiles and footwear, should help sustain high growth in merchandise exports. This assumption may not appear implausible given recent good performance against global headwinds, although a projected flat real effective exchange rate will not boost price competitiveness, and growth in Italy, the main export market, will remain subdued. The

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



Source: Economic and Fiscal Programme (EFP) 2014, ECFIN calculations programme also expects services exports to rebound quickly, but such outcome seems unlikely in the absence of structural changes furthering tourism investments that in any case might take time to yield results. With the expected start of some big investments in the later years of the programme, imports might gather steam and lead to a bigger than forecast current account deficit, but such higher external gap will be matched by FDI inflows funding these projects. Remittances are seen decreasing further in 2014 before recovering slightly in the later years of the programme, while the income account is set to deteriorate due to increased repatriation of profits by foreign investors. At a macroeconomic level, the narrowing of the current account shortfall is projected to be supported by a continuing trend toward higher private savings and a shrinking government deficit. Overall, the balance of risks surrounding the expected path of the current account deficit is titled to the downside.

Securing sizeable FDI inflows will be key to financing the external deficit and modernising the economy. In recent years, Albania managed to attract a relatively stable level of FDI inflows that financed the bulk of the current account deficit, with private companies relying very little on external financing via credit lines. However, with privatisation options largely exhausted, the focus should now shift to creating favourable conditions for greenfield investments. Opportunities exist in hydropower generation, agribusiness and tourism, among others, but exploiting them will require tackling sector specific as well as more general impediments in the business environment, such as strengthening the rule of law and solving the long-standing issue of property rights. The EFP expects FDI inflows to increase by about 6 % a year on average over the programme, so that they would exceed the current account deficit in all years except 2014. Some large projects already in the pipeline (such as a large hydropower plant and the Albanian section of the Trans-Adriatic Pipeline) lend support to this assumption, but further efforts will be necessary to fully benefit from FDI's knock-on benefits on productivity and economic diversification. In any event, after obtaining substantial loans from the IMF and the World Bank, balance of payment pressures should not create any concerns in the coming years.

A dearth of credit risks delaying the recovery. Following a steady deceleration of annual growth in the stock of outstanding loans from September 2011, lending started to contract in mid-2013, with business loans especially feeling the crunch. Sluggish credit demand in the midst of the economic slowdown might have played a part in this, but banks' increased risk-aversion and tight credit conditions following an enduring deterioration in their loan portfolio also had a strong negative impact. High government borrowing, especially in the first half of 2013, might have also crowded out some private lending. In addition to lowering its policy rate, the central bank initiated in mid-2013 a number of macroprudential and regulatory measures to support credit growth, such as temporarily easing capital needs for new lending, lowering liquidity requirements, promoting early loan restructurings and facilitating collateral execution. However, the deadlock still persists and may only get a decisive boost from the arrears clearance programme, which is expected to improve confidence while lowering non-performing loans.

Despite very high NPLs and lingering credit risks, the banking sector appears fundamentally stable. Capital and liquidity ratios largely exceed requirements and deposits continued to be the main source of funding for banks, which have very limited reliance on external sources and parent bank credit lines. NPLs stood at 23.7 % in April 2014, but they seem to be levelling off after almost five years of steady increase. Loan losses are also well provisioned, which has weighed on banks' earnings. However, profitability indicators remain positive and have been improving since the fourth quarter of 2013. A stress test exercise that analysed the stability of the banking sector under various adverse scenarios until end-2014 concluded that only mid-sized banks would face the need to raise capital as a result of negative shocks. A particular credit risk stems from the currency mismatch of borrowers with foreign currency loans but domestic currency income. Such loans made up 31.1 % of the total stock in September 2013 and are particularly sensitive to a large exchange rate depreciation.

Table II.1.2:
Financial sector indicators

	2009	2010	2011	2012	2013
Total assets of the banking system, mEUR	2,287	2,301	2,287	2,471	2,427
Foreign ownership of banking system					
Credit growth	20.5	8.6	11.7	7.4	-1.3 Q3
Bank loans to the private sector %	100.0	100.0	100.0	100.0	100.0
Deposit growth	-0.1	15.5	14.5	9.4	2.4 Q3
Loan to deposit ratio	0.67	0.63	0.62	0.61	0.58 Q3
Financial soundness indicators					
- non-performing loans	9.1	12.6	17.0	21.7	24.3 Q3
- core capital to risk weighted assets	16.2	15.4	15.6	16.2	17,8 Q3
- liquid to total assets	27.7	26.0	26.5	29.4	27.6
- return on equity	2.4	7.3	2.0	5.2	-1.7 Q3
- forex loans to total loans %	70.3	68.6	67.5	64.6	61.4 Q3

Sources: National Central Bank, Ecowin/Reuters

1.3. PUBLIC FINANCE

A tendency of underperforming revenues and missed fiscal targets intensified in 2013. Large budgetary slippages, caused mainly by disappointing revenue from direct taxes and spending increases in the first half of the year that were linked to the election cycle, necessitated a substantial revision of the budget in October 2013. This increased the full-year deficit target to 6.2 % of GDP, up from 3.5 %, although a downward revision of nominal GDP also played a small part. Due to a surge in VAT and excise revenues at the end of the year, which might have been related to the anticipation of tax changes taking effect in 2014, and thanks to the curbing of capital expenditure, the eventual deficit was somewhat better at 4.8 % of GDP. Still, total revenues fell 0.5 % year-on-year and were 8.9 % lower than initially planned, continuing their decline as a share of GDP from 26.6 % in 2010 to 24.2 % in 2013. Revenue from VAT, the largest item on the revenue side, dropped by 3.1 % compared with 2012 and was 12 % less than anticipated in the initial budget. In terms of expenditure, efforts to contain the budget shortfall focused again on cutting the traditionally flexible item, capital spending, which, after a substantial tightening in the second half of the year, ended up 7.8 % lower than initially planned, although it did increase marginally as a share of GDP (to 4.8 %). Total expenditure-to-GDP increased from 28.6 % in 2012 to 29 % in 2013.

Going forward, the stated objective of fiscal policy is to consolidate public finances while clearing government arrears. This translates into deficit targets of 6.5 % of GDP in 2014, 4.8 % in 2015 and 3.4 % in 2016 that incorporate the front-loaded settling of accumulated arrears amounting to 2.5 % of GDP in 2014, 1.3 % in 2015 and 1.2 % in 2016. The budget adjustment over this period is planned to come from increasing revenues as a share of GDP by 2.3 percentage points, i.e. back to their 2010 level, drawing on a series of tax rises as well as gains from improved administration. At the same time, total expenditure net of arrears clearance is projected to decrease slightly as a share of GDP to 28.8 % in 2016, while capital expenditure is assumed to remain at around 5 % of GDP (including a new contingency line). With a focus on the deficit, there is no immediate plan to re-establish a statutory debt ceiling following the breach and abolition of the 60 % limit in 2010. Also, the EFP emphasises that deficit targets will be implemented with some flexibility in order to limit potential pro-cyclical effects.

Table II.1.3:
Composition of the budgetary adjustment (% of GDP)

	2012	2013	2014	2015	2016	Change: 2013-16
Revenue	24.9	24.2	25.7	26.0	26.5	2.3
- Taxes and social security contributions	20.0	19.6	20.6	21.1	21.6	2.0
- Other (residual)	4.9	4.6	5.1	4.9	4.9	0.3
Expenditure	28.4	29.0	32.2	30.8	29.9	0.9
- Primary expenditure	25.3	25.8	28.9	27.3	26.3	0.5
of which:						
Gross fixed capital formation	5.2	5.6	5.5	5.8	5.7	0.1
Consumption	9.0	9.0	9.2	8.8	8.4	-0.6
Transfers & subsidies	10.7	11.2	11.3	11.2	11.0	-0.2
Other (residual)	0.4	0.0	2.9	1.5	1.2	1.2
- Interest payments	3.1	3.2	3.3	3.5	3.6	0.4
Budget balance	-3.5	-4.8	-6.5	-4.8	-3.4	1.4
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-0.4	-1.6	-3.2	-1.3	0.2	1.8
Gross debt level	62.5	70.5	72.1	71.7	69.2	-1.3

Sources: Economic and Fiscal Programme (EFP) 2014, ECFIN calculations

The 2014 budget aims to reverse the decline in revenues through a combination of tax rises, tax expenditure cuts and improved collection. Total revenues are projected to increase by some 11 % over 2013, lifting the revenue-to-GDP ratio by 1.5 percentage points to 25.7 %. Some 53 % of the revenue growth is expected to come from tax increases and exemption removals (see box for more details). The rest is dependent on economic growth projections being fulfilled, in particular a 4.4 % increase in nominal GDP and a forecast 6 % rise in the value of imports — the latter being the main driver behind a similar surge in expected VAT revenues. Improvements in tax governance are also seen to yield some (unspecified) benefits. On the expenditure side, total spending is set to rise by 15.8 % year-on-year, but with the main items largely held constant as a share of GDP, it is the clearance of a large chunk of arrears that drives up the overall expenditure-to-GDP ratio from 29 % to 32.2 %.

Box: The budget for 2014

The parliament adopted the 2014 state budget on 28 December 2013.

The consolidation measures are focusing on the revenue side, while the clearance of arrears pushes up total expenditure.

Table: Main measures in the budget for 2014

Revenue measures*	**Expenditure measures****
• Lifting VAT and excise exemptions in the hydrocarbon sector **(0.4 % of GDP)**	• Increase in interest expenses **(0.2 % of GDP)**
• Increasing excise taxes on cigarettes, tobacco, alcoholic beverages and beer **(0.3 % of GDP)**	• Rise in reserve fund **(0.1 % of GDP)**
• Increase in circulation tax on fuels **(0.4 % of GDP)**	• Clearance of arrears **(2.5 % of GDP)**
• Removing the local small business tax and replacing it with a 7.5% tax on the profit of small businesses **(-0.1 % of GDP)**	
• Increase in the corporate income tax rate from 10% to 15% **(0.5 % of GDP)**	
• Introducing a progressive personal income tax **(-0.1 % of GDP)**	
• Doubling the existing tax on buildings (both commercial and residential) **(0.1 % of GDP)**	
Total tax revenues effect (1.5 % of GDP)	**Total expenditure effect (2.8 % of GDP)**

* Estimated impact on general government revenues.
** Estimated impact on general government expenditure.
Source: EFP 2014

The direction and composition of revenue adjustment are broadly appropriate, but subject to some downside risks. The overall tax burden leaves room for raising revenues, and the commendable aim of consolidating public finances while also tackling accumulated arrears, makes tax increases necessary. Broadening the tax base for VAT and excise duties and raising some indirect taxes are measures normally considered less distortive. However, the significant increase in corporate income tax for larger firms, while efficient from the point of view of administration and compliance, might have a negative influence on investment, unless counterbalanced by reducing the arbitrariness of tax collection and improving the overall business environment. As for the expected rise in tax intake, the recent trend in overestimating receipts and a persistent decline in the revenue-to-GDP ratio call for some caution; in particular, risks stem from optimistic projections for GDP.

Beyond 2014, the path of budgetary consolidation depends on economic growth. Apart from further raising some excise rates in 2015 and 2016 and scrapping certain VAT exemptions in 2015 in line with EU requirements, the EFP does not foresee further tax rises in the later years. Expected revenue increases will thus have to rely on economic growth as well as improved administration. With the phasing out of spending on arrears repayment and the emergence of some savings from cuts in the number of public employees, expenditure as a share of GDP should fall back and the budget is expected to post a small primary surplus in 2016, its first since 2010.

Box: Alternative scenarios

Mindful of the risks surrounding the baseline assumptions, the programme presents alternative scenarios and the budget contains increased buffers.

In particular, a low growth and a favourable growth scenario, together with their effect on public finances, are considered beside the baseline assumption. In case of feeble growth, a somewhat lower tax elasticity is also part of the assumptions, whereas the baseline and favourable scenarios both count on more efficient tax collection. In the low growth scenario, recovery is expected to be sluggish, with real GDP growth of only 0.4 % in 2014, 1.1 % in 2015 and 2.4 % in 2016, with a corresponding negative impact on revenues. Under this scenario, half of the revenue shortfall is offset by spending cuts, mostly affecting a newly established contingency line for capital expenditure (amounting to 0.8 % of GDP in 2015 and 1.3 % in 2016), while the rest increases the deficit (to 7.1 % in 2014, 5.8 % in 2015 and 4.6 % in 2016). Similarly, in case of more robust growth than planned, half of the extra revenue would be used for public investment, and only the remaining part would lower the deficit.

Presenting alternative scenarios clearly enhances the soundness of the programme; however, they also make clear that the burden of any adjustment on the expenditure side continues to be placed on capital spending. This underscores the need for sound public finances that preserve room for growth-enhancing expenditure items.

Recognising arrears pushes up the already elevated debt level, while rollover risks remain high. Unpaid bills and outstanding tax refunds have thus far not been captured by official debt statistics; recognising and settling them therefore constitutes a major step forward in terms of transparency, even if it means that the headline debt figure will substantially increase. Total public debt is expected to peak at 72.1 % of GDP in 2014 before falling back to 69.2 % in 2016, thanks to the emergence of a primary budget surplus and the expected robust growth. Under the low growth scenario, debt reaches 75.8 % in 2015 and decreases only slightly thereafter. Even though efforts to lengthen the maturity profile of the debt stock achieved some results in 2013 (notably with a first successful issuing of a 10-year bond), the short term component of domestic debt remains high, exposing the country to refinancing risks. The narrow investor base, which comprises mainly domestic banks, adds to the vulnerabilities. Even if interest rates on government securities declined markedly in 2013 as a result of banks' ample liquidity and limited investment opportunities, this could change if private lending gathers steam. A particular risk stems from the need to refinance a large Eurobond equivalent to 4.5 % of GDP which matures in 2015.

Table II.1.4:

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

	2012	2013	2014	2015	2016
Gross debt ratio [1]	**62.5**	**70.5**	**72.1**	**71.7**	**69.2**
Change in the ratio	2.2	8.0	1.7	-0.4	-2.5
Contributions [2]:					
1. Primary balance	**0.3**	**1.6**	**3.2**	**1.3**	**-0.2**
2. "Snow-ball" effect	**1.2**	**1.7**	**0.3**	**-0.4**	**-1.0**
Of which:	0.0	0.0	0.0	0.0	0.0
Interest expenditure	3.1	3.2	3.3	3.5	3.6
Growth effect	-0.8	-0.4	-1.4	-2.3	-2.8
Inflation effect	-1.2	-1.0	-1.6	-1.7	-1.8
3. Stock-flow	**0.7**	**4.6**	**-1.8**	**-1.3**	**-1.3**

Notes:

[1] End of period.

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

Source: Economic and Fiscal Programme (EFP) 2014, ECFIN calculations

Large IMF-WB loans are expected to finance arrears clearance. Risks in terms of financing the deficit in the years to come are largely mitigated by budget support loans expected to be secured from international organisations, primarily the IMF and the World Bank([1]). The EFP puts their total amount at around €720 million over the years 2014-2016, and assumes, without providing further details, a substantial degree of flexibility that would allow an increase in the loan amounts in case low growth punches a larger hole in the budget.

Public finance management is in need of an overhaul. The accumulation of large unpaid bills and other arrears over the years reflect substantial weaknesses in budgetary planning and execution. Apart from tackling these arrears, it is equally important to avoid their re-emergence, which requires a thorough improvement in budget planning, commitment control and the management of investment projects. The EFP refers to some broad objectives in this respect without setting out the intended measures, as the complete reform package was still being developed. The government has since made progress by issuing an arrears clearance and prevention strategy.

1.4. STRUCTURAL REFORMS

Structural impediments to growth are numerous and well understood. Improving the business environment by strengthening the legal and regulatory framework, including property rights and the efficiency of public administration, combating corruption and the informal economy, tackling the long-standing problems of the energy sector and the pension system, and improving labour market outcomes by ensuring adequate education and training are vital to unleashing the economy's potential. The programme is good at providing a list of the main obstacles, but the measures proposed, though helpful in themselves, are often restricted to enumerating on-going schemes or, at the other end of the spectrum, they vaguely refer to future strategies being elaborated. As such the EFP measures fall short of providing the strategic push needed to dismantle the country's main bottlenecks to growth.

([1]) The IMF approved a 3-year €330.9 million arrangement in February, while two World Bank development policy loans, with a combined amount of $220 million, were granted in May.

Weaknesses in the business environment are not addressed in a comprehensive manner. The measures mentioned include the opening of the Administrative Court, which is expected to speed up the settlement of administrative disputes, small-scale credit schemes to help micro and small enterprises access financing, a further reduction in the (already competitive) time to register new businesses, and plans to step up labour inspections to fight tax evasion. A long-term public administration reform strategy, to be implemented in several phases starting in 2014, is being drafted with the aim of developing capacities, improving public services and ensuring the efficient management of human resources. However, settling the perennial issue of weak property rights, including the completion of first property registration, legalisation of illegal buildings and compensation for expropriated former owners, is neglected in the programme, as are other weaknesses such as delays in obtaining construction permits.

The energy sector is poised to undergo much-needed changes. An almost exclusive reliance on hydropower exposes Albania to large fluctuations in power generation, and large electricity imports in low-rainfall years have a negative impact on the current account balance. Moreover, weaknesses in the regulatory and legal framework governing the relations between key players mean that the state acts as a financier of last resort, which poses a constant threat to public finances. The EFP foresees a number of important changes, including the adoption of a new electricity sector law to further liberalise the market and encourage private investors in electricity production; and efforts to increase the capacity of transmission and interconnection networks, notably with a financial agreement already in place for the construction of the Albania-Kosovo interconnection line. A new large hydropower project that will significantly boost generation capacity is also imminent. Another major investment planned is the Trans-Adriatic Pipeline that will cross Albania's territory and holds out the prospect of introducing gas to the energy mix in the longer term. Nevertheless, significant weaknesses in the electricity sector remain and need to be addressed. These include a lack of financial viability, high levels of losses in electricity distribution, low bill collection rates, tariffs below cost-recovery level and an on-going dispute with the former owner of the renationalised energy distributor.

Generating employment and improving the quality of education and training remain major challenges. The registered unemployment rate is stuck at a stubbornly high level (close to 13 %), and estimates based on labour force surveys put the number even higher (17 % in the fourth quarter of 2013) and on an increasing trend. While some aspects of the labour market, such as the ease of hiring and firing or the link between pay setting and productivity, display sufficient flexibility, other aspects point to significant structural impediments. For example, there is a high proportion of subsistence farmers in the agriculture sector, which still employs close to half of the workforce. There is also a high prevalence of long-term unemployment and large gender differences in labour force participation. Worryingly, more than 30 % of youths are neither in employment nor education nor training. Despite wide-ranging reforms in the past, the quality of education and training is still weak; enhancing and reorienting them to better match market needs would improve the employability of the workforce and Albania's potential to attract higher value-added investments. The EFP refers to the imminent completion of the National Employment and Skills Strategy that will run until 2020 and aims at overhauling active labour market policies, improving vocational education and training, reforming social safety nets and strengthening the governance of the labour market. Turning the strategy into effective action, however, will likely prove challenging.

Without reform, the pension system risks imposing a growing burden on public finances. In Albania's pay-as-you-go system, overall pension spending is relatively low thanks to the young population, but a series of unfunded benefit increases, heavily subsidised contributions for agricultural workers, disincentives for higher-income earners, and low participation rates due to the widespread informal economy, mean that the system is in deficit which is set to increase further under unchanged policies. The EFP recognises the problem and a pension reform strategy, drawing on the expertise of international financial institutions, is in the making.

1.5. ANNEX: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

Albania's Council of Ministers approved the programme on 29 January 2014 and submitted it to the European Commission on 31 January. The EFP is in line with the annual budget for 2014 and the Macroeconomic and Fiscal Framework 2015-2017. Plans regarding fiscal policy were closely consulted with the IMF and World Bank. The programme is largely consistent with the assessments in the European Commission’s Progress Reports.

Macro framework

The programme presents a reasonably comprehensive picture of past developments. Almost all the relevant data are covered, but weaknesses remain, not least regarding the labour market and wage statistics. The macroeconomic framework, albeit optimistic, is sufficiently comprehensive. Links between the macroeconomic scenario and the structural reform measures could have been made more explicit. As a sign of clear improvement over the previous years, the programme complements the baseline assumption with alternative scenarios. There remains ample room for enhancing the analysis of external sustainability.

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the presented macroeconomic scenario even if it seems optimistic. There are some gaps in the data presented and the explanation on how revenue projections had been derived could have sometimes been made clearer. Fiscal data are not in full compliance with ESA95 standards.

Structural reforms

The structural reform framework could have been made more coherent and comprehensive. The programme would have benefited from better focusing on the major structural reforms and providing more details and a clear timeline for them, along with estimates of their budgetary impact. Some challenges that are identified as being among the main obstacles to growth are left unaddressed by the proposed measures.

2. BOSNIA AND HERZEGOVINA

2.1. EXECUTIVE SUMMARY

Since the onset of the crisis, the economy of Bosnia and Herzegovina has been adversely affected by the economic situation in its main EU trade partners along with the negative contribution of weak domestic demand, the continuous political stalemate and a difficult investment climate. Thus, despite the export-driven resumption of economic growth in 2013, the economic recovery remains fragile and risks are clearly tilted to the downside.

In a slightly optimistic scenario, the EFP forecasts GDP growth to accelerate from 1.5% in 2013 to 3.5% in 2016 and relies heavily on the recovery of domestic demand. In particular, the programme's projections for investment growth appear on the upside and would certainly require determined action to revive the privatisation process and, not least, a stronger commitment by the authorities to undertake immediate decisive steps to improve the business environment, which remains one of the most challenging in the region. Key downside risks are also related to the heavy flooding in the spring, which has severely damaged transport and energy infrastructure as well as production and is expected to take a toll on short-term GDP growth. In addition, the difficult political situation and the general elections scheduled for October could adversely affect the timely implementation of much needed, growth supporting structural reforms.

External imbalances, which substantially narrowed in 2013 on the back of growing exports in particular in the energy sector, along with a continuous decrease of imports, are projected to widen again beyond 2014 with domestic demand recovery gaining speed. However, the increase in external balances could be somewhat muted as the average rate of growth in imports might be less strong than programmed, given the still weak domestic demand, while the dynamics of exports might continue over the programme period. At the same time, the programmed acceleration of FDI inflows in 2014-2016, although boosted by some energy projects already in the pipeline, and projected to finance more than two thirds of the current account deficit, seems somewhat optimistic.

Although budget imbalances improved somewhat in the last two years with the budget deficit edging down to 1% of GDP in 2013, fiscal policy needs to be anchored in a credible medium-term framework. The authorities intend to embark on an ambitious fiscal strategy over the programme period based on expenditure consolidation of 5.8 percentage points of GDP over 2014-16. The foreseen expenditure cuts are broad-based with both capital and current spending generally declining as a percentage of GDP. However, these adjustments would need to be backed by the design and bold implementation of structural fiscal reforms which cannot be taken for granted, given the country's track record. Revenues, estimated in a conservative manner, significantly decline as a percentage of GDP, despite the planned broadening of the revenue base as well as foreseen improvements in tax collection.

The authorities recognise the need for decisive actions to improve the composition of expenditures; however, the EFP does not provide a convincing and fully elaborated strategy to shift spending towards a more growth-enhancing pattern. Consolidated general government expenditures increasingly dominated by current spending, even before the crisis, have settled their share at close to 95% in recent years at the expense of capital outlays, which served as a fiscal buffer. Planned measures to improve the targeting of social spending –currently accounting for over 14% of GDP and with a significant part related to the 1992-1995 war- remain limited. In addition, the programmed employment increase in the public sector in 2014 is not in line with the envisaged administrative reform and will further increase the already high public sector wage bill of about 12% of GDP exceeding by a wide margin the regional average.

Persistent structural weaknesses pose a considerable threat to the long-term growth prospects of the economy. In particular, both the dysfunctional labour market and the low quality of human capital remain key concerns. The modest recovery of the economy of Bosnia and Herzegovina in 2013 failed to unwind the labour market and alleviate the negative impact of the crisis, especially on low-skilled workers and youth employment. The sluggish progress of reforms in other areas (i.e business environment, privatisation) has also not been conductive to employment creation. The unemployment rate, above 27% of the labour force, remains persistently high and the activity rate of 43.6% remarkably low. The EFP generally recognises the significant economic challenges and structural bottlenecks to growth, but the programme's policy response remains fragmented. It focuses mainly on several active labour market policies and fails to address other structural problems, such as the high level of labour taxation and poorly targeted social transfers.

Private sector development in Bosnia and Herzegovina continues to be hampered by an unfavourable business environment as shown by its falling ranking in various international surveys. The main challenges include the still high barriers for starting business, the strengthening of the legal and regulatory framework, the enforcement of contracts, improving access to financing, and enhancing political stability .The authorities acknowledge the importance of creating a more favourable business environment and accordingly the EFP discusses the adoption of a set of amendments of relevant laws aiming to facilitate procedures related to business creation, in particular in the Federation. As to the concrete measures the programme remains weak and does not present a clear timeline for their implementation.

2.2. ECONOMIC OUTLOOK AND RISKS

The EFP projects a strengthening of the pace of recovery, owing to a strong and rising contribution from domestic demand. GDP is foreseen to accelerate from an estimated 1.5% in 2013 to 2.3% in 2014, 2.8% in 2015 and 3.5% in 2016. While output growth in 2013 was equally supported by domestic demand and net exports, the EFP projects domestic sources to become the engine of growth as of 2014. The programme relies on a marked surge of investments with an average growth of 9.2% in 2014-16, supported by a strong increase in foreign-financed projects, notably in energy. Private consumption growth is also projected to accelerate, but at a much more moderate pace, reflecting high unemployment and limited scope for a strong pick-up in disposable incomes. Government consumption would only gradually expand due to fiscal consolidation needs. The contribution from the external side is expected to turn negative in 2014, and increasingly so in the outer years of the programme period, in view of strong import growth, which will eventually exceed the growth of exports in 2016. In line with the growth scenario, labour market conditions are set to slowly improve, though with only limited gains in total employment.

The EFP's macroeconomic scenario appears slightly optimistic and risks are tilted to the downside. Following the recession in 2012, there has been a recent pick-up in economic activity and domestic demand is likely to strengthen going forward. Somewhat improved lending conditions and slowly rising incomes, also supported by an expected slight recovery of remittances as well as the gradual completion of infrastructure projects are likely to support stronger growth. However, in view of the difficult investment climate in the country, the EFP's projections for solid investment growth appear somewhat optimistic and would certainly require a stronger commitment by the authorities to undertake immediate decisive steps to improve the business environment, which remains one of the most challenging in the region. In addition, action to re-engineer the privatisation process, especially in the Federation, would support private sector development. Key downside risks to short-term growth are related to the heavy flooding in the spring, which have severely damaged transport and energy infrastructure as well as production. In addition, the current difficult political situation and the general elections scheduled for October could adversely affect the timely implementation of much needed, growth supporting structural reforms. Risks on the external front stem from a renewed deterioration in the economic environment in the EU which could weaken exports and capital inflows. In addition, enduring problems with the trade with Croatia after its EU accession still constitute a risk for exporting industries in the agricultural sector. Furthermore, while the Stand-By Arrangement (SBA) with the IMF remains on track and a nine-month extension has been granted in January 2014, any prolonged delay in the implementation of committed policies, similar to the failure to timely conclude the sixth review of the SBA in February putting on hold the respective disbursement, would result in significant financing difficulties with potential repercussions on economic growth.

Table II.2.1:

Macroeconomic developments and forecasts

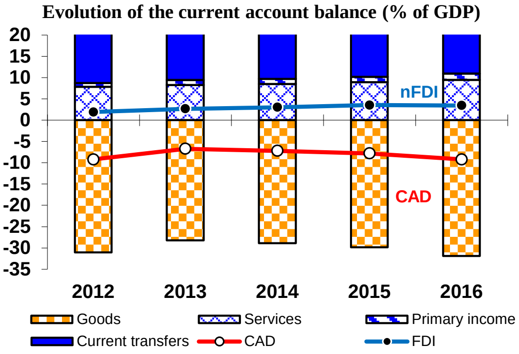
	2012	2013	2014	2015	2016
Real GDP (% change)	-0.9	1.5	2.3	2.8	3.5
Contributions:					
- Final domestic demand	-0.2	0.8	3.0	3.5	5.4
- Change in inventories	0.4	-0.1	-0.1	0.2	0.0
- External balance of goods and services	-1.1	0.8	-0.6	-0.9	-1.9
Employment (% change)	-0.3	1.0	0.5	1.4	2.2
Unemployment rate (%) LFS	28.0	27.5	27.5	27.1	26.4
GDP deflator (% change)	2.5	2.6	1.7	1.7	1.4
CPI inflation (%)	2.1	0.3	1.5	1.6	1.5
Current account balance (% of GDP)	-9.2	-6.7	-7.2	-7.8	-9.2

Sources: Economic and Fiscal Programme (EFP) 2014

External imbalances are on the rise confirming the structural nature of the current account deficit. A decline in international energy prices and sluggish import demand, resulting from weaker private consumption and fiscal consolidation measures, as well as rising energy exports, contributed to a narrowing of the current account deficit to 5.5% of GDP in 2013, down from 9.2% in 2012. However, this improvement will be of a temporary nature, and external vulnerabilities are likely to persist. The EFP projects total exports to expand by around 6.5% on average in 2014-16, largely backed by a recovery in the EU, which accounts for over 70% of total exports. Slower growth in the EU would thus significantly weaken exports. In addition, the failure of domestic producers to meet the quality standards required by the accession of Croatia to the EU, albeit limited to some agricultural products, puts an additional break on export expansion. The demand-driven recovery will at the same time boost imports, due to the high import intensity of domestic investment and production. Thus, the outlook is for a rising current account deficit, reaching again 9.2% of GDP by 2016, as projected in the EFP. The strong correlation of higher output growth and rising external imbalances reflect the persistence of structural weaknesses with limited production diversification, a narrow export base and low productivity levels.

Graph II.2.1:

Evolution of the current account balance (% of GDP)



Source: Economic and Fiscal Programme (EFP) 2014, ECFIN

Attracting FDI will be crucial for financing rising external imbalances and for enhancing the productive capacity of the economy. In recent years, net FDI inflows have significantly declined, from an average of some 5% of GDP in the run-up to the crisis to 1.9% of GDP in 2013 and have furthermore been characterised by a low sectoral diversification. The EFP expects a strong increase in FDI inflows to about 6.9% of GDP by 2016. However average net inflows will on average cover only two-thirds of the current account deficit over the programme period. Moreover, FDI inflows are foreseen to be primarily boosted by some energy projects already in the pipeline, thus diversifying the narrow production base but still leaving scope for a further productivity increase. In addition, as the contribution of new privatisation projects tends to be limited due to its broad completion in Republika Srpska and the denationalisation standstill in the Federation, the focus should be increasingly put on attracting greenfield investments in sectors others than energy. Opportunities exist in tourism as well as in agribusiness and in the manufacturing of wood products, among others, but their development would hinge on the improvement of the business environment, in particular with regard to the strengthening the rule of law, enforcement of contracts, starting a business and financing of small and medium-sized enterprises.

Labour market conditions will remain difficult. The tepid recovery in 2013 did not translate into an improvement of the labour market situation. On the contrary, the employment rate decreased further, while registered unemployment edged up to a worryingly 44.1% in March 2014. Going forward, the EFP foresees employment levels to rise by 0.5% in 2014, 2.1% in 2015 and 2.7% in 2016 on the back of the foreseen recovery. In the short term, most of the employment gains will materialise in the public sector, especially in 2014, which appears to be in contradiction with the government's intention to streamline public sector employment in the context of the envisaged public administration reforms. Private sector job creation remains muted and will only gain some pace in the outer years of the programme period.

Financial stability increasingly comes under pressure. The quality of the loan portfolio has been steadily deteriorating since the outbreak of the crisis and the share of NPLs in total loans reached 14.9% as of end March 2014. Loan losses provisioning seems adequate but translated into a negative impact on profitability. Profitability indicators in 2013 were on a downward path and turned temporarily negative as of end-2013. Nonetheless, banks are still well capitalized with a regulatory capital adequacy ratio of some 17% and liquidity indicators remain at comfortable levels. Furthermore, the new planned legislation on asset management and tax treatment of loan sales to be adopted in the course of 2014 aims to further strengthen the banking sector.

A sustained economic recovery requires a rebound in credit activity. Private sector credit growth almost halved to 2.5% year-on-year in 2013 on the back of slower dynamics of credits in the household sector. In addition, the continuous deterioration of the credit portfolio in 2013, albeit at a slower pace, weighs on the resumption of lending growth and on economic recovery thus stressing the importance of the planned establishment of a NPL resolution framework. Against this background, the EFP's projection of a substantial acceleration of credit (and deposit) growth to 10% in 2016 appears somewhat optimistic. On the deposit front, the growth of total deposits accelerated to 5.1% year-on-year in 2013 allegedly pushed as well by precautionary motives. Accordingly, the dependence on foreign financing has gradually declined with the loan-to-deposit ratio adjusting downwards from over 122% in 2008 to currently 115.2%, thus reflecting the increasing reliance on domestic sources of funding.

Table II.2.2:
Financial sector indicators

	2009	2010	2011	2012	2013
Total assets of the banking system, mEUR	10,742	10,828	11,196	11,414	11,994
Credit growth	5.4	-0.9	5.6	5.2	2.5
Bank loans to the private sector	53.0	52.2	51.5	48.6	47.6
Deposit growth	-4.0	4.7	2.6	2.6	5.1
Loan to deposit ratio	1.16	1.16	1.18	1.20	1.15
Financial soundness indicators					
- non-performing loans	4.5	9.1	12.0	12.7	14.9 Q3
- net capital to risk weighted assets	16.1	16.2	17.1	17.0	17.0 Q3
- liquid to total assets	30.9	29	27.2	25.4	25.3 Q3
- return on equity	0.8	-5.5	5.8	7.0	3.9 Q3
- forex loans to total loans	73.9	70.1	66.9	63.1	64.1

Sources: National Central Bank, DataInsight

2.3. PUBLIC FINANCE

The general government deficit in 2013 is broadly in line with the original budget. The EFP estimates that the fiscal deficit amounted to 1% of GDP which is slightly above the target in the budget from December 2012 but below the deficit of 1.5% of GDP in 2012. On the revenue side, the impact of the modest revival of economic activity was only partly offset by a decrease of social contributions resulting into a minor increase of total revenue-to-GDP ratio to 42.6% of GDP. However, the elevated VAT refunds continued to pose an additional drag on revenues from indirect taxes, the latter accounting for two-thirds of total tax revenues. On the spending side, consolidation measures in 2013 such as the freeze of public sector wages and restrictive employment policy in both entities and the central government as well as additional measures such as the one-off cut of salaries in Republika Srpska, (albeit effectively lower than originally foreseen), provided space for a rise in capital investment by a 45% year-on-year, though, from a low base. Thus, consolidated fiscal expenditures are projected to have remained broadly unchanged at 43.6% of GDP.

Despite some consolidation efforts, the deficit is projected to increase in 2014 to 1.6% of GDP. In contrast to the previous year, the fiscal measures of the programme for 2014 and beyond are planned mainly on the revenue side, especially in the Republika Srpska. Total revenue-to-GDP ratio is expected to decline to 40% of GDP in 2014 due to reductions in all categories, which is not consistent with the optimistic macroeconomic scenario and the envisaged measures for broadening the revenues base (such as through the new Law on Games of Chance and amendments to the Law on tax administration in the Federation). In addition, an improvement of the collection of indirect taxes is set to be achieved through strengthening the capacity of the Indirect Tax Authority among others, although this might prove to be challenging against the background of increasing VAT refunds. Furthermore, several measures in Republika Srpska tend to be expansionary such as the introduction of non-taxable income in the amount of 200 KM and will additionally weaken the personal income tax returns. The expenditures in 2014 will remain broadly on the level of 2013 in nominal terms, while decreasing as a percentage of GDP. The improvement of the composition of expenditures which started in 2013 seems to be partly offset by some measures such as the increase of the price of labour from KM 100 to KM 106 in Republika Srpska, which impacts public sector wages, while the budget of the Federation foresees to cut expenditures primarily through the audit of some social transfers and to rationalise material costs.

The fiscal adjustment in 2014 should be based on the timely implementation of reforms to improve the quality of public finances and hinges on the impacts of the recent spring floods. The authorities generally recognise the need for decisive actions to improve the composition of expenditures and to shift spending towards a more growth-enhancing pattern. However, the EFP does not provide targeted measures to this end and the projected capital-to-GDP ratio is forecasted to decline to 3.3% of GDP in 2014. Equally, the programme generally remains silent on the measures aiming to control more rigorously and to decrease social transfers currently accounting for over 14% of GDP. As for the expected increase of revenue efficiency, the recent trend of high and growing VAT refunds poses a considerable threat to the projections of revenues despite the forecasted rise in imports in 2014 and calls for the timely implementation of envisaged measures to strengthen the indirect tax collection and to broaden the tax base. In addition, the heavy spring flooding puts the envisaged fiscal adjustment at significant risk.

Over the medium term, the stated objective of fiscal policy is to consolidate public finances with the budget coming close to a balance. The EFP presents a medium-term strategy, which foresees to lower expenditures below 40% of GDP by 2016. The reduction of the budget deficit is to be back-loaded to 2016 with an improvement of the general government deficit by 0.4 percentage point of GDP- from 1% of GDP in 2013 to 2.0% of GDP in 2015 and 0.6% of GDP in 2016. However, the fiscal framework lacks a description of the underlying fiscal and structural reform measures to support the spending and deficit reductions. General government expenditures will edge down by 5.8 percentage points of GDP (from 43.5% of GDP in 2013 down to 37.8% of GDP in 2016), which seems to be overly ambitious. In particular, capital spending and subsidies are planned to experience a decrease to 3.1% and 1.2% of GDP in 2016 respectively, while the nominal decrease of all other categories seems to be less steep and is back loaded in the outer year of the programme period. On the revenue side, the total-revenue-to-GDP ratio is projected to decline substantially with an annual adjustment of 1.8 percentage points of GDP on average to reach 37.2% of GDP due to unfavourable developments in all revenue categories. However, the conservative projection of revenues is somewhat in contradiction with the macroeconomic scenario and the intended measures for tax broadening and enhanced tax collection.

The ambitious fiscal strategy faces non-negligible fiscal risks, while lacking a comprehensive description of the supporting measures beyond 2014. The programme remains silent on specific measures to tackle pressing reforms such as the high taxation of labour (and high social contribution rates, in particular), especially in the Federation. In addition, the lack of a comprehensive reform of the social transfers system to improve the targeting of social benefit recipients questions the credibility of the strategy, given the country's track record in implementing unpopular reforms. Furthermore, the programme fails to elaborate on the plans for a reform of the public administration that would underpin the stated aim of a reduction of the current expenditures.

Table II.2.3:
Composition of the budgetary adjustment (% of GDP)

	2012	2013	2014	2015	2016	Change: 2013-16
Revenues	41.7	42.6	40.0	38.2	37.2	-5.4
- Taxes and social security contributions	36.0	36.1	34.3	33.1	32.3	-3.8
- Other (residual)	5.7	6.5	5.7	5.1	4.9	-1.6
Expenditure	43.5	43.6	41.6	40.2	37.8	-5.8
- Primary expenditure	42.9	42.8	40.8	39.4	37.1	-5.7
of which:						
Gross fixed capital formation	2.7	4.0	3.3	3.4	3.1	-0.9
Consumption	19.7	19.0	18.3	17.5	16.6	-2.4
Transfers & subsidies	17.8	17.3	16.6	16.0	15.2	-2.1
Other (residual)	2.7	2.5	2.6	2.5	2.2	-0.3
- Interest payments	0.6	0.8	0.8	0.8	0.7	-0.1
Budget balance	-1.8	-1.0	-1.6	-2.0	-0.6	0.4
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-1.2	-0.2	-0.8	-1.2	0.1	0.3
Gross debt level	37.6	37.0	37.6	34.7	30.7	-6.3

Sources:Economic and Fiscal Programme (EFP) 2014, ECFIN calculations

Box: The budget for 2014

The parliaments of both entities adopted their budgets in December 2013 before the expiration of the last year's budget year and thus demonstrating their commitment to a timely budget laws endorsement.

The envisaged consolidation measures for 2014 and beyond are focusing primarily on the revenue side, in particular including measures to improve tax collection and to broaden the revenue base, while some of the measures on the expenditure side tend to be somewhat expansionary, especially in Republika Srpska.

Table: Main measures in the budget for 2014

Revenue measures	Expenditure measures
• Indirect taxation reform **(0.05% of GDP)**	
• Law on Games of Chance in the Federation **(0.1% of GDP)**	• Veterans-disability protection audit in the Federation **(0.02% of GDP)**
• Amendments to the Law on Tax Administration the Federation **(0.1% of GDP)**	Increase of minimum labour price from KM 100 to KM106 in Republika Srpska **(-0.04% of GDP)**
• Law on the amount of the default interest rate on public revenue in the Federation **(0.05% of GDP)**	
• Introduction of non-taxable income of 200 KM in Republika Srpska **(-0.1% of GDP)**	

Source: EFP 2014

The structure of the public debt does not pose an immediate concern. Bosnia and Herzegovina's public debt is projected to fall to 30.7% of GDP in 2016 from estimated 37% of GDP in 2013. In particular, domestic public debt is projected to progressively decline to 7.7% of GDP on the back of a steady decrease of verified old currency savings and war claims. A decline of foreign public debt is expected only after 2015 as the withdrawal of tranches under the IMF SBA leads to an increase of the debt in 2014. The currency structure of the total public debt can be considered relatively favourable given the country's currency board arrangement, as 31.4% of the outstanding stock is denominated in EUR and 38.4% in domestic currency. A large part of the debt stock has been contracted on concessional terms with the average interest rate remaining at 1.44% and some 55% of total debt under a fixed interest rate. The maturity structure is quite favourable with the average repayment period of the existing loan commitments estimated at 11.2 years.

Re-financing risks are nevertheless elevated. Public debt servicing, which soared over twofold in recent years and reached over 4.5% of GDP in 2013, is projected to surge by a further one third in 2014, thus posing high refinancing risks , given the tight fiscal space of the country especially against the backdrop of the spring floods. Bosnia and Herzegovina has no access to international capital markets. Thus, any significant delays in the implementation of already agreed reforms under the Stand-By Arrangement with the IMF would additionally increase the already elevated financing risks. In particular, the main risks in the Federation stem from the rollover of domestic debt and the potential market saturation, while legal limits on the accumulation of domestic public debt limit the high rollover in Republika Srpska. Furthermore, the limited availability and the slow progress of other sources of budget financing (e.g. Development Policy Loan with the World Bank) pose a major risk to the elevated refinancing needs in both entities.

Table II.2.4:

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

	2012	2013	2014	2015	2016
Gross debt ratio [1]	**37.6**	**37.0**	**37.6**	**34.7**	**30.7**
Change in the ratio	4.1	-0.6	0.6	-2.9	-4.0
Contributions [2]:					
1. Primary balance	**0.1**	**0.8**	**-0.8**	**-0.8**	**-1.7**
2. “Snow-ball” effect	**0.1**	**-0.8**	**-0.7**	**-0.9**	**-1.0**
Of which:					
Interest expenditure	0.6	0.7	0.7	0.7	0.7
Growth effect	0.3	-0.5	-0.8	-1.0	-1.1
Inflation effect	-0.9	-0.9	-0.6	-0.6	-0.5
3. Stock-flow	**2.8**	**-0.1**	**0.6**	**-3.0**	**-2.9**

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: Economic and Fiscal Programme (EFP) 2014; ECFIN calculations

2.4. STRUCTURAL REFORMS

The economy of Bosnia and Herzegovina faces significant structural obstacles to growth and suffers from a low competitiveness. In particular, there is an urgent need for business environment-related reforms to unlock the potential for development of the private sector. Related to this is the still large share of the public sector in the economy and the pressing need for privatisation and enterprise restructuring. In addition, besides the size of the informal economy remaining a key challenge, it is imperative to address the low quality of the human capital and to enhance the functioning of the labour market to combat the persistently high unemployment. Generally, the concrete reform measures proposed in the programme remain piecemeal and thus fail to provide a comprehensive response to the economic challenges the country is facing.

Reforms related to the improvement of the business environment need to be accelerated urgently. Although the EFP discusses the adoption of a set of amendments of relevant laws aiming to simplify procedures related to business creation, in particular in the Federation, such as amendments to the Law on Business Registration as well as the Law on Companies and Inspections aiming to simplify and shorten business registration, it nevertheless fails to deliver concrete measures and a respective timeline for their implementation. In addition, there is ample room for further measures to improve the business environment through the strengthening of the legal system and of contract enforcement and addressing the issue of property rights and attracting FDI.

The re-launch of the privatisation process to achieve efficiency gains is essential but receives limited attention. Large-scale privatisation remains an unfinished task, especially in the Federation. After the majority of the privatisation deals launched in the Federation in 2013 have failed due to lack of investors' interest, the Privatization Plan for 2014 foresees the sale of 11 state enterprises, most of them with a majority state ownership. Although the privatisation process in Republika Srpska is more advanced with 2/3 of companies identified for privatisation already sold, the denationalisation plan for 2014 is far from ambitious. Only 5 companies with state-ownership are planned to be offered for sale in 2014. Overall, given the broad stalemate of privatisation deals in 2013 and the absence of privatisation plans beyond 2014 in the EFP, decisive steps would need to be taken to improve the efficiency of companies with state ownership.

Structural rigidities impeding sustained labour market improvements are generally recognised but barely addressed. The modest revival of economic growth in 2013 did not translate into labour market improvements. In particular, the share of long-term and youth unemployed remains high, while the informal economy is still an important provider of jobs. Moreover, the very low participation rate suggests there is an inactivity trap caused by generous and poorly targeted social benefits. The EFP generally points at these bottlenecks. However, major new initiatives have been generally limited to a few selective measures such as plans to reduce the tax burden for employers to combat informal employment as well as preparations for new labour laws in both entities aiming to reduce disincentives for new employment and to enhance the flexibility of the labour market. However, the recent stalemate in the adoption of the new labour laws in both entities poses a considerable drag on the improvement of the labour market.

The reform of the pension system in the Federation is finally gradually advancing. The new Law on Pension and Disability Insurance in the Federation is planned to be adopted in 2014. It foresees a gradual increase of the age of early retirement and a tightening of eligibility conditions for disability and survivor's pensions. Similar to the effects of the pension system reform in Republika Srpska implemented in 2012, it is expected to improve the sustainability of public finances in the Federation. With a view to achieving such objective, the new law also considers the establishment of a two-pillar pension system although it can potentially cause short-term costs and would call for a proper policy mix to address other factors bearing a negative impact on the functioning of the labour market.

The financial sector regulatory framework is set to be strengthened. Against the background of steadily rising NPLs edging up to 14.9% as of March 2014, which weigh on the already subdued bank lending, it is crucial to implement measures to safeguard financial stability. Thus, the steady progress in the drafting of the new banking laws in line with EU directives along with the continuation of the implementation of the Basel II requirements for risk assessment and management ensuring also consistency between the entities is conductive for strengthening the regulatory framework. In addition, a resolution framework for the high share of NPLs advances through the drafting of a new legislation on asset management companies as well as the tax treatment of loans sales.

2.5. ANNEX: OVERALL ASSESSMENT OF PROGRAMME REQUIREMENTS

Bosnia and Herzegovina submitted its 2014 Economic and Fiscal Programme, covering the period 2014-2016, on 30 January 2014. The programme, which has been adopted by the Council of Ministers of Bosnia and Herzegovina, is in line with the government's medium-term fiscal strategy. Like in previous years, the programme would have benefited from establishing a closer link to the country’s accession process, such as the assessments in the European Commission’s Progress Reports. While it broadly complies with the required content and form, there are several inconsistencies between the text and the delivered data as well as selective data gaps. It also suffers from insufficient coordination between state-and entity levels to produce a more unified and consistent text.

Macro framework

The presented macroeconomic framework in the 2014 EFP is broadly plausible even though the growth scenario is somewhat optimistic and subject to some non-negligible downside risks. The medium-term macroeconomic scenario is based on the assumptions of the Commission's autumn forecast as regards the external environment. The credibility of the presented medium-term programme would have benefited from a more thorough analysis of the downside risks and the elaboration of alternative scenarios, considering there are still prevailing uncertainties. The 2014 EFP complies with the Commission's request to provide an assessment of the medium-term sustainability of the country's external position. The recent macroeconomic performance is adequately described and it includes most relevant information available at the time of drafting. The analysis would have benefited from presentation of alternative scenarios besides the baseline assumption in the programme.

Fiscal framework

The fiscal framework lacks a comprehensive description of medium-term measures beyond 2014, which would support the targeted consolidation and fiscal goals. In addition, the programme would have greatly benefited by the quantification of often only briefly mentioned measures. The compilation and presentation of fiscal data is not yet fully in line with GFS methodology and there are no roadmaps for the introduction of ESA95. Some data inconsistencies and discrepancies point to the still low quality of budgetary reporting and suggest possible simultaneous use of different methodologies by the spending units and/or the consolidating institution.

Structural reforms

The programme lists the main growth bottlenecks but fails to present a thorough analysis, as requested by the Commission. The structural reform strategy is vague on medium-term measures beyond 2014. There is ample room for improvement in terms of supporting the reform intentions with specific measures, quantifying their budgetary impact and presenting a timeframe for their implementation.

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