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2015 Economic Reform Programmes (Part I) of Albania,
The former Yugoslav Republic of Macedonia, Montenegro,
Serbia, Turkey, Bosnia and Herzegovina and Kosovo*:
The Commission's overview and country assessments



Economic and
Financial Affairs

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European Commission

Directorate-General for Economic and Financial Affairs

2015 Economic Reform Programmes (Part I) of Albania, The former Yugoslav Republic of Macedonia, Montenegro, Serbia, Turkey, Bosnia and Herzegovina and Kosovo*

The Commission's overview and country
assessments

* This designation is without prejudice to positions on status,
and is in line with UNSCR 1244/1999 and the ICJ Opinion
on the Kosovo declaration of independence.

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INTRODUCTION

Economic governance has become one of the three fundamental pillars in the enlargement process over the past years, mirroring similar developments at the EU level related to the establishment of the European Semester for Member States. In its 2013 and 2014 enlargement strategies, the Commission outlined a new approach to economic governance. It implies an important change in the economic policy dialogue with enlargement countries with a view to giving clearer guidance on the reforms needed to foster macroeconomic stability, ensure fiscal sustainability and support long-term growth and competitiveness. In this spirit, the Joint Ministerial dialogue between the Economic and Finance Ministers of the EU and the candidate countries on 6 May 2014 already provided, for the first time, more targeted policy guidance for each candidate country.

In October 2014 the Commission invited all enlargement countries to enhance economic policy and its governance through the preparation of annual Economic Reform Programmes (ERPs). These programmes comprise two parts.

- Part I consists of an enhanced version of the previous Pre-Accession Economic Programmes (PEP) for candidate countries and Economic and Fiscal Programmes (EFP) for potential candidates and was extended also to include, for the first time, Kosovo⁽¹⁾. Part I sets out a medium-term macro-economic and fiscal policy framework, as well as macro-structural reform measures to directly support the policy framework.
- Part II, a new addition, covers structural reforms which are sectoral in nature, aimed to improve physical and human capital, industrial structures, the business environment and trade integration in order to boost competitiveness and long-term growth in the individual countries⁽²⁾.

The ERP exercise also aims to help candidate countries and potential candidates to develop their institutional and analytical capacities and to prepare them for participation in the EU's multilateral surveillance and economic policy coordination procedures upon accession.

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessment of Part I of the ERPs for 2015-2017 submitted in early 2015 by Albania, the former Yugoslav Republic of Macedonia, Montenegro, Serbia and Turkey (i.e. the countries officially recognised as candidates for EU membership) as well as Bosnia and Herzegovina and Kosovo. All of the above seven programmes have been made public⁽³⁾. For the first time, the country assessments also take stock of the extent to which the country-specific policy guidance adopted last year has been implemented. Turkey transmitted its programme with a substantial delay, allowing only for a reduced assessment. The cut-off date for the analysis was 10 April 2015.

The assessment was prepared in the Directorate-General for Economic and Financial Affairs under the guidance and coordination of István Jakab and Uwe Stamm. The principal authors were Hans Berend Feddersen (Turkey), Mariya Hake (Bosnia and Herzegovina), Plamen Kaloyanchev (Serbia), Ivan Kusen

(1) This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

(2) Turkey has not been asked to submit Part II of the ERP on the grounds that it is already considered a functioning market economy.

(3) Albania: http://www.financa.gov.al/files/userfiles/Programimi_EkonomikoFiskal/Programi_Ekonomik_e_Fiskal/NERPNational_Economic_Reform_Program/Albania_NERP_2015.pdf;

the former Yugoslav Republic of

Macedonia: http://www.finance.gov.mk/files/u9/29.01.2015%20NERP%20EN%20final_0.pdf;

Montenegro: <http://www.mf.gov.me/en/news/145799/Montenegro-Economic-Reform-Programme-2015-2017.html>;

Serbia: <http://www.mfin.gov.rs/pages/article.php?id=10544>;

Bosnia Hz.: http://www.dep.gov.ba/Default.aspx?langTag=en-US&template_id=139&pageIndex=1;

Kosovo: <https://mf.rks-gov.net/en-us/Reports/Reports-and-Publications/National-Economic-Reform-Programme>

Turkey: <http://www.mod.gov.tr/Lists/PreAccessionEconomicPrograms/Attachments/14/Pre-Accession%20National%20Economic%20Reform%20Program%202015.pdf>

(Kosovo), Antonio Sanchez Pareja (Montenegro), Barbara Stearns-Blasing (the former Yugoslav Republic of Macedonia) and András Tari (Albania).

The programmes and the Commission staff's assessment were discussed at experts' level in two multilateral meetings held in Brussels on 21 April and 30 April 2015 and at Ministerial level at the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey held in the margins of the ECOFIN Council on 12 May 2015. Representatives from EU Member States, enlargement countries, the European Central Bank and the Commission attended these meetings.

The Joint Conclusions discussed and adopted at the May Economic and Financial Dialogue include country-specific policy guidance related to both Part I and Part II of the ERP. The conclusions are available online⁽⁴⁾. In addition, the relevant parts of the conclusions containing the country-specific policy guidance are also reproduced in this paper at the end of each country assessment chapter.

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(⁴) <http://www.consilium.europa.eu/en/press/press-releases/2015/05/12-ecofin-joint-conclusions/>

Part I

Horizontal Overview of the 2015 Programmes

1. HORIZONTAL OVERVIEW OF THE 2015 PROGRAMMES

Table 1.1.1:
Economic Reform Programmes 2015
Key indicators

	2011	2012	2013	2014e	2015	2016	2017
Real GDP growth (% change)							
Albania	2.5	1.6	1.4	2.1	3.0	4.0	4.5
The former Yugoslav Republic of Macedonia	3.0	-0.4	2.7	3.7	4.0	4.2	4.5
Montenegro	3.2	-2.5	3.3	2.0	3.5	3.8	4.0
Serbia	1.4	-1.0	2.6	-2.0	-0.5	1.5	2.0
Turkey	8.8	2.1	4.1	3.3	4.0	5.0	5.0
Bosnia and Herzegovina	1.0	-1.2	2.5	1.1	3.4	4.0	4.4
Kosovo	4.4	2.8	3.4	3.3	4.1	4.3	4.6
Unemployment rate (% LFS)							
Albania	13.4	13.8	16.1	17.3	16.4	15.3	13.9
The former Yugoslav Republic of Macedonia	31.4	31.0	29.0	28.0	27.0	25.9	24.8
Montenegro	19.7	19.7	19.5	19.4	18.2	17.6	17.2
Serbia	23.0	23.9	22.1	20.0	21.3	20.9	19.8
Turkey	9.2	8.4	9.0	9.6	9.5	9.2	9.1
Bosnia and Herzegovina	27.6	28.0	27.5	27.5	27.0	26.4	25.6
Kosovo	44.8	30.9	30.2	29.0	28.7	28.1	27.4
Current account balance (% of GDP)							
Albania	-13.2	-10.2	-10.6	-12.0	-11.9	-12.6	-12.8
The former Yugoslav Republic of Macedonia	-2.5	-2.9	-1.8	-2.7	-3.9	-4.6	-4.1
Montenegro	-17.7	-18.7	-14.6	-14.2	-13.3	-13.8	-14.6
Serbia	-8.6	-11.5	-6.1	-6.1	-4.7	-4.5	-4.3
Turkey	-9.7	-6.1	-7.9	-5.7	-5.4	-5.4	-5.2
Bosnia and Herzegovina	-9.6	-9.2	-5.5	-6.8	-6.4	-5.7	-5.0
Kosovo	-13.7	-7.5	-6.4	-6.3	-6.1	-6.6	-6.8
Inflation (CPI, annual % change)							
Albania	3.5	2.0	1.9	1.6	2.5	2.8	3.0
The former Yugoslav Republic of Macedonia	3.9	3.3	2.8	-0.3	2.0	2.2	2.2
Montenegro	3.1	4.1	2.2	-0.5	1.0	1.5	2.0
Serbia	7.0	12.2	7.8	2.1	2.7	4.0	4.0
Turkey	6.5	8.9	7.5	8.9	7.2	5.5	5.0
Bosnia and Herzegovina	3.7	2.0	-0.1	-0.7	1.0	0.9	1.2
Kosovo	7.3	2.5	1.8	0.8	0.4	0.6	0.4

Sources: Economic Reform Program (ERP) 2015 for 2013-2017, CCEQ for 2011 and 2012.

The programmes of most of the Western Balkan countries project a marked reacceleration of growth over the next three years, which appears somewhat optimistic. While the (unweighted) average real economic growth in the six countries was 2.7% in 2013 (and due to the recession in Serbia, a mere 1.7% in 2014 according to first estimates), the ERPs uniformly expect a gradual strengthening of economic activity with growth projected to reach 4% on average in 2017. With the forecast recovery in the EU, the main trading partner of Western Balkan countries, the external environment is indeed likely to be more favourable than in the immediate aftermath of the crisis, although underdeveloped export sectors relying on foreign sales of a narrow range of products will not help to make full use of this. With the exception of Serbia, the ERPs project domestic demand to be the main growth driver, boosted by large public and private investments and stronger household consumption, helped by a generally low-inflation environment and some employment gains. However, the risks surrounding this outlook remain clearly tilted to the downside. A still difficult business environment does not favour a strong pick-up in private investment, while public capital expenditure projects are often characterised by significant delays as well as cost overruns. Also, a dire labour market situation in most

of the countries will continue to constrain disposable incomes and demand.

Reliance on foreign savings is a common feature of these economies. The saving-investment gap is reflected in current account deficits, which in some cases are substantial as a proportion of GDP. Furthermore, the projected domestic-demand led growth is not conducive to narrowing these external shortfalls. However, to the extent that deficits are generated and financed by foreign direct investment (FDI) inflows, external sustainability concerns remain muted. In some cases, fiscal consolidation is expected to support increased national saving, thus helping to contain external imbalances. Still, there remains ample space across the countries to improve conditions for attracting FDI into tradable sectors and fostering closer links with domestic firms, thereby benefiting more extensively from its knock-on benefits on productivity and economic diversification.

Table:

Economic Reform Programmes 2015
Fiscal indicators

	2011	2012	2013	2014e	2015	2016	2017
Total revenue* (% of GDP)							
Albania	25.5	24.9	24.0	25.9	27.8	27.8	27.9
The former Yugoslav Republic of Macedonia	31.9	31.9	30.2	31.6	31.6	31.0	30.2
Montenegro	39.7	41.3	43.4	46.2	42.9	41.4	40.3
Serbia	41.0	41.5	39.7	40.9	40.3	39.1	38.2
Turkey	36.4	37.8	40.0	39.1	38.2	37.7	37.3
Bosnia and Herzegovina	40.0	41.7	40.8	40.2	38.9	36.5	35.0
Kosovo	n.a.	n.a.	24.7	23.9	26.8	25.6	24.8
Total expenditure* (% of GDP)							
Albania	29.0	28.4	28.9	31.0	31.7	30.4	29.2
The former Yugoslav Republic of Macedonia	34.4	36.6	34.2	35.4	35.0	34.2	33.2
Montenegro	45.2	47.4	47.7	47.7	48.2	46.4	44.3
Serbia	46.0	47.9	45.0	48.9	46.1	43.8	41.9
Turkey	36.8	38.9	40.7	39.8	38.7	37.8	37.2
Bosnia and Herzegovina	40.7	43.5	42.3	42.1	40.6	38.1	35.6
Kosovo	n.a.	n.a.	27.8	26.4	28.9	27.4	26.6
General government balance (% of GDP)							
Albania	-3.6	-3.5	-4.9	-5.1	-3.9	-2.6	-1.3
The former Yugoslav Republic of Macedonia	-2.5	-4.0	-4.0	-3.8	-3.5	-3.2	-3.0
Montenegro	-5.5	-6.1	-4.8	-1.5	-5.3	-5.0	-4.0
Serbia	-5.0	-6.4	-5.3	-7.9	-5.8	-4.7	-3.8
Turkey	-0.4	-1.0	-0.7	-0.8	-0.5	-0.2	0.1
Bosnia and Herzegovina	-0.7	-1.9	-1.5	-1.8	-1.7	-1.6	-0.6
Kosovo	-1.7	-2.5	-3.1	-2.6	-2.1	-1.8	-1.8
General government debt (% of GDP)							
Albania	60.3	62.5	70.1	71.8	71.6	68.8	65.6
The former Yugoslav Republic of Macedonia	27.9	34.3	34.1	37.7	35.5	37.3	38.7
Montenegro	44.4	54.0	58.1	59.6	63.2	67.0	69.1
Serbia	50.3	60.9	61.1	69.9	77.7	79.2	78.7
Turkey	39.1	36.2	36.2	33.1	31.8	30.0	28.5
Bosnia and Herzegovina	35.5	37.6	37.2	40.5	38.9	36.0	31.7
Kosovo	5.3	8.1	9.0	10.6	12.4	13.4	14.5

Sources: Economic Reform Programme (ERP) 2015 for 2013-2017
* 2011 data from PEP/EFP 2013, 2012 data from PEP/EFP 2014, Kosovo data from CCEQ.

which include the need to upgrade labour force skills in line with market needs, cement the rule of law, cut red tape, rationalise public services and restructure state-owned companies. In some countries, there are some positive signs of an emerging reform drive. On balance, however, tackling deep-seated problems would require from governments across the region more vigorous efforts, a sustained commitment, and the willingness to take on vested interests.

On **Turkey**, the Commission's assessment stresses that: (1) the growth projections are optimistic, (2) the economy is continuing to face a very large external deficit associated with significant external financing risks, (3) the persistently elevated level of domestic inflation remains a macroeconomic challenge on the domestic side, (4) the fiscal deficit is relatively moderate and public debt at a sustainable level, but the fiscal policy stance should be tighter in cyclically adjusted terms in view of the need to increase national saving, and (5) the structural reform chapter is mainly backward looking and does not elaborate on specific measures, for instance, to improve the investment climate.

Fiscal consolidation remains high on the policy agenda. The economic crisis has taken a toll on budgets and sent the public debt of most of the countries on an upward trajectory. Reversing this trend has become a priority in many of them. Policy plans are often ambitious, but subject to significant downside risks in light of a widely shared track record of missed revenue targets partly offset by cuts in capital expenditure. This should be avoided in future and fiscal consolidation should be pursued in a growth-friendly way, having regard to the large existing investment needs across the Western Balkans. It should be noted that significant cross-country differences exist in the state's economic weight, which accounts for the differences in the emphasis placed either on revenue or expenditure measures.

Reviving stalled economic convergence with the EU requires ambitious structural reforms. The economic crisis has also put a stop to the region's catching-up process, and Western Balkan per capita incomes remain stuck at a level much below the EU average. Labour markets characterised by very high unemployment rates and a high prevalence of informal jobs further exacerbate the economic hardship. The ERPs demonstrate that governments are to a large extent aware of the main structural challenges to reinvigorate growth and generate jobs,

Part II

Country analysis

1. ALBANIA

1.1. EXECUTIVE SUMMARY

After the sharp deceleration of economic growth that followed the crisis, Albania's economy now seems to be experiencing a gradual upturn. This is being driven by private sector demand, with household spending benefiting from improved confidence and some employment gains and businesses enjoying better liquidity conditions, thanks to the government's decision to tackle its arrears.

Albania's medium-term programme realistically projects that economic performance will gain further traction between 2015 and 2017, as the external environment gradually improves and large FDI projects in the energy sector raise investment. The recovery is expected to be supported by an appropriate policy mix involving monetary easing and continued fiscal consolidation. An accommodative monetary policy is warranted given the low level of consumer price inflation, which has remained below the central bank's target range of 2 %-4 % for the last two years as the negative output gap, low imported inflation and a stable exchange rate generated little upward pressure on prices. Although the budget outcome was commendable in 2014, continued fiscal rectitude is necessary to lower vulnerabilities stemming from the high level of public debt (more than 70 % of GDP) with its sizable short-term component that exposes the country to rollover risks. The government remains committed to fiscal consolidation and aims to lower the debt ratio to below 66% in 2017 by raising taxes and taking steps to further improve tax collection in 2015, as well as tightly controlling expenditure thereafter.

Although accelerating, at just 3.8 % per year, the average annual rate of output growth expected by the programme over the next three years is far lower than it was before the crisis and subject to downside risks. Albania's banks, though largely well-capitalised and liquid, are still burdened with a high proportion of bad loans, a legacy of overextension in the boom years and the subsequent downturn. The country is also highly exposed to some vulnerable EU countries through trade, remittances and financial flows. The woes of the electricity sector, which relies almost exclusively on weather-dependent hydropower, also pose risks to the economic and fiscal outlook.

The high import content of investment in Albania means that the current account deficit is set to deteriorate further in the coming years, despite the expected continuing increase in exports. The large external deficit, at more than 12 % of GDP, reflects a narrow production and export base, as well as the sizable saving-investment gap, which, due to high investment needs, should be reduced in the longer term as the national saving rate rises along with output and income levels. This underscores the need to improve the investment environment to attract foreign direct investment and ensuring that it continues to finance the bulk of the current account deficit while laying the foundations for higher productivity and output.

Improving longer-term growth prospects in order to rekindle convergence with advanced economies in the EU and generate much-needed jobs in the formal sector requires structural reforms in several areas, and the government seems eager to address many of them. Important steps have been taken to improve public finance management and avoid the recurrence of arrears, even if much remains to be done. Efforts are ongoing to devise and adopt a fiscal rule to build confidence about public finances in the longer term, when the country's current IMF agreement which acts as a short-term anchor runs out. The reform of the pension system, aiming to improve its long-term sustainability, has been largely accomplished. The tax administration is being overhauled with the help of a new IT-system, reducing opportunities for arbitrary practices, fraud and corruption. The electricity sector is a major arena for reforms, which is well warranted by the scale of the problems. The regulatory business environment is being streamlined with

some first positive results already visible. Vocational education, labour market policies and the health sector are also the targets of important initiatives.

Other important obstacles to growth that need sustained efforts to address include the state of property rights, the rule of law, the informal economy, corruption and labour force skills. Advances in the EU integration process, including the granting of candidate status to Albania in June 2014, should maintain the pressure for further substantial improvements. At the same time, a proper sequencing of reforms will be important, so that the pace of implementation matches the available administrative capacity.

1.2. ECONOMIC OUTLOOK AND RISKS

The programme projects a gradual recovery in growth driven by domestic demand. Private consumption should get a boost from improving confidence and less precautionary saving than in the immediate post-crisis years. Projected labour market gains are seen lifting household disposable income and supporting their spending. Real growth in investment is forecast to be even more robust at close to 10 % a year on average, fuelled by strong FDI inflows, improved liquidity in the wake of large-scale clearance of government arrears, and better financial conditions. On the other hand, the planned fiscal consolidation leaves little room for public consumption to expand, while the external sector is expected to be a drag on growth as higher domestic absorption drives up imports. On the production side, the programme projects a steady improvement in all branches of the economy, with the biggest growth contribution coming from services and the extractive industry.

Table II.1.1:

Macroeconomic developments and forecasts

	2013		2014		2015		2016		2017	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	1.4	1.4	1.7	2.1	3.0	3.0	3.5	4.0	n.a.	4.5
<i>Contributions:</i>										
- Final domestic demand	0.8	0.8	3.1	3.1	4.1	3.1	4.8	5.1	n.a.	5.1
- 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	0.6	0.6	-1.4	-1.0	-1.1	-0.1	-1.3	-1.1	n.a.	-0.6
Employment (% change)	-0.8	-0.8	0.8	0.9	1.7	2.8	1.9	3.7	n.a.	4.3
Unemployment rate (%)	16.1	16.1	17.5	17.3	16.6	16.4	15.6	15.3	n.a.	13.9
GDP deflator (% change)	0.8	0.8	1.5	1.4	1.9	2.5	2.5	2.8	n.a.	3.0
CPI inflation (%)	1.9	1.9	1.6	1.6	2.0	2.5	2.5	2.8	n.a.	3.0
Current account balance (% of GDP)	-10.6	-10.6	-12.8	-12.0	-12.9	-11.9	-13.5	-12.6	n.a.	-12.8

Sources: Economic Reform Programme (ERP) 2015, Commission 2015 Winter Forecast (COM)

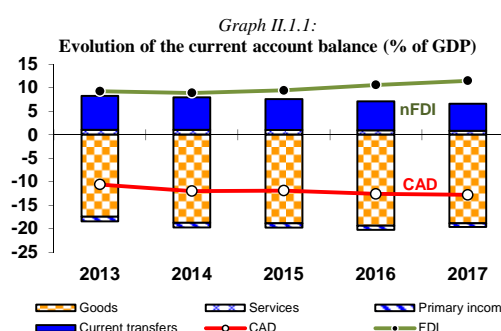
The assumed growth trajectory is broadly plausible but subject to downside risks. Economic sentiment has indeed shown a gradual improvement since the trough reached in the third quarter of 2013. In 2013 as a whole, private domestic demand reversed the fall it had recorded a year earlier and indirect indicators suggest a continuation of this trend in 2014. The upswing in the business cycle has so far been slow but it gets support from the policies of a reform-minded government, which in 2014 cleared almost half of the total stock of arrears (worth 5.3 % of GDP), with the balance expected to be paid by the end of 2016. On the other hand, the timid uptick in lending is vulnerable to the still unfinished repair of bank balance sheets as well as to potential deleveraging pressures in case of financial stress in the euro area. With the projected slow recovery in the EU, the external environment is expected to improve gradually. However, Albania's exposure in terms of trade, financial links and remittances to Italy and Greece means that any unfavourable development in these countries might hit it hard as well. The sanguine outlook also faces risks on the production side. In particular, weather conditions traditionally cause large fluctuations in hydropower-based electricity generation, whose growth contribution varied widely in recent years, ranging from -0.9 pps. in 2011 to 0.6 pps. in 2013. Furthermore, the sharp drop in international oil prices,

while being a boon to consumers, could interfere with the expected step-up in Albanian crude oil production.

Medium-term growth prospects remain well below pre-crisis levels. The programme expects real GDP to grow by 3.8 % a year on average between 2015 and 2017, compared with an average annual expansion of 6 % over 2004-2008. In the latter period characterised by a benign external environment, economic performance was buoyed by strong household spending and an often double-digit rate of construction growth, benefiting from robust remittances inflows and a credit boom. As these sources of growth have been largely exhausted, the potential rate of economic expansion has come substantially down. While the pre-crisis growth model might have relied on unsustainable factors, it is clear that Albania needs a prolonged period of strong growth to support its catching-up process and absorb the projected expansion of the labour force. This underscores the need to implement structural reforms that could lift long-term economic potential and materially raise living standards.

Monetary easing supports the gradual closing of the output gap and the return of inflation towards target. Inflation remained below the Bank of Albania's 3 % \pm 1 pp. target in both 2013 and 2014 as a result of weak aggregate demand, low imported inflation and a stable exchange rate. This enabled a monetary easing cycle to unfold in several steps over the last few years, even if high risk premia and banks' increased risk aversion hampered its pass-through to the economy. The gradual closing of the negative output gap, which the programme expects for the first half of 2016, will put upward pressure on prices but an expected prolonged period of low inflation in Albania's main trading partners, as well as weak commodity prices, will continue to dampen price rises. Overall, inflation is likely to undershoot the programme's expectations, especially in 2015. This suggests that monetary policy will remain accommodative in the period ahead and thus supportive of fiscal consolidation and an appropriate policy mix.

The current account deficit is structurally high and is likely to widen further. With a narrow production and export base, Albania's merchandise trade gap has traditionally been sizeable at around 20 % of GDP. The cyclical weakness of domestic demand contributed to its contraction in 2012 and 2013, but the high import content of recovering consumption and investment led the trade gap to worsen again in 2014 even though exports have also continued to grow. Remittances, which prior to 2009 used to offset more than half of the merchandise trade deficit, covered less than a third of it in 2013 as transfers from crisis-hit Greece and Italy greatly diminished. Even if the decline halted in 2014, a structural change in terms of migrant workers' loosening links with their home country means that this source of income is unlikely to play a bigger role in future. At the same time, the growing stock of foreign investment results in higher outflows of investment earnings. Overall, the programme projects, realistically, that the current account deficit will exceed 12 % of GDP in the next three years. The large deficit reflects the savings-investment gap caused by high investment needs coupled with relatively low savings. In the longer term, the gap should be reduced by increasing the national saving rate on the back of higher output and thus income. The envisaged fiscal discipline, too, should contribute to higher domestic saving.



Source: Economic Reform Programme (ERP) 2015, ECFIN calculations

The financing of the current account deficit remains generally healthy and external sustainability concerns are muted. In the period 2009-13, more than two-thirds of the current account shortfall was financed by net inflows of foreign direct investment, even if the coverage was somewhat lower in 2014. Gross external debt amounts to around 65 % of GDP, with long-term debt making up more than 80 % of the total, mostly in the form of government borrowing and inter-company lending. International reserves, covering around 4.3 months of imports of goods and services, provide an adequate safeguard against

adverse shocks and Albania can also draw on resources made available to it under a three-year EUR 330 million IMF arrangement approved in February 2014. The programme expects foreign direct investment inflows to remain sizeable (related notably to two major projects in the energy sector: a large hydropower plant and the Albanian section of the Trans-Adriatic gas pipeline) and finance some 80 % of the current account deficit over the next three years. Nevertheless, given Albania's pressing need to diversify its economy and improve productivity, the country continues to face the challenge of attracting foreign capital through substantial improvements in the investment environment, such as in the areas of property titling, contract enforcement and the rule of law.

Lending to the economy remains subdued despite supportive policy measures. In the absence of capital markets, bank loans constitute the main source of external funding for the economy. With lending to businesses and households amounting to 40 % of GDP, there is ample scope for deeper financial intermediation. However, despite the favourable liquidity position of banks and notwithstanding monetary easing which has contributed to a gradual fall in credit rates, lending growth has been anaemic since early 2013 and only started to gather some momentum towards the end of 2014. While the economic slowdown has dampened demand for loans, the stubbornly high proportion of non-performing loans, which levelled off but was still close to 23 % at the end of 2014, has greatly contributed to banks' increased risk aversion. In addition, conservative lending policies due to deleveraging pressures on some EU-based parent banks have also played a part in the credit slowdown. Various regulatory and legislative changes have already been implemented to foster loan restructurings, stimulate write-offs and facilitate collateral enforcement, and their positive impact might continue to unfold in 2015. However, as the programme also acknowledges, further efforts remain necessary to encourage the clean-up of bank balance sheets and unplug financial intermediation. The Bank of Albania has also attempted to use macro-prudential tools to steer the credit cycle, such as reducing capital requirements for banks that expand their loan book within a certain range, as well as discouraging them from holding foreign assets. These temporary measures will remain in place until June and December 2015, respectively.

The banking system appears stable but is not immune to manifest credit and sovereign risks. Overall the capital and liquidity ratios of the banking system largely exceed regulatory requirements and banks profitability has been improving due to a diminishing need to set aside provisions for loan losses. Banking activity continues to be fundamentally financed by deposits, with the loan-to-deposit ratio standing at around 55 %. However, as mentioned above, non-performing loans remain high, and even if they are relatively well provisioned, net NPLs still amount to around 50 % of bank capital. Moreover, despite a decreasing tendency, the high euroisation of the economy remains a concern, as it exposes banks to credit risks: foreign currency loans to unhedged borrowers still make up around a third of the total loan stock, making their repayment vulnerable to a sharp depreciation of the lek. Also, since government securities constitute 25 % of bank assets (making domestic banks the largest holders of domestic government debt with a share of 60 %), a severe sovereign debt stress is bound to affect bank solvency. The programme is conscious of these risks and also reports the results of a stress test exercise which has identified relatively limited recapitalisation needs even in the severely adverse scenario combining assumptions of declining credit growth, rising interest rates and a marked depreciation of the lek.

Table II.1.2:

Financial sector indicators

	2010	2011	2012	2013	2014
Total assets of the banking system, mEUR	7,329	8,374	8,884	9,316	9,717
Foreign ownership of banking system	93	93	93	93	93
Credit growth, aop	8.6	11.7	7.4	-0.2	0.2
Deposit growth, aop	15.5	14.5	9.4	3.7	1.5
Loan to deposit ratio, eop	0.60	0.61	0.58	0.55	0.55
Financial soundness indicators, eop					
- non-performing loans to total loans	12.6	17.0	21.7	24.0	22.8
- core capital to risk weighted assets	15.4	15.6	16.2	18.0	16.8
- liquid to total assets	26.0	26.5	29.4	27.6	32.4
- return on equity	7.6	0.8	3.8	6.4	10.5
- forex loans to total loans	67.5	65.2	61.2	59.9	58.3

Sources: Economic Reform Programme (ERP) 2015, Bank of Albania, Data Insight

1.3. PUBLIC FINANCE

Reversing the trend of disappointing revenues and missed deficit targets of recent years, the budget performed well in 2014. The 2014 deficit outcome, at 5.1 % of estimated full-year GDP, undershot the target of 6.3 % that had already been revised downward in September from the initial plan of 6.6 %. Reflecting rate hikes as well as efforts to improve tax collection, revenues increased by 12.1 % year-on-year, broadly in line with the revised plan, thus lifting the revenue-to-GDP ratio to 25.9 % from 24 % a year earlier. The biggest contribution came from a 10.6 % year-on-year surge in net VAT receipts, benefiting from both growing final demand and better tax collection. However, it was the shortfall in expenditure that kept the deficit below target. Despite a late-year surge in investment spending that tried to offset earlier large slippages, total capital expenditure undershot the budgeted amount by a substantial margin. Also operating spending underperformed, causing total expenditure to remain 3.9 % below plan. Overall, the 2014 deficit was only slightly higher than a year earlier, which is remarkable, given that the budget also had to accommodate the repayment of a large portion of government arrears to businesses, amounting to 2.4 % of GDP. Net of this extraordinary expense, which in effect amounts to paying down old debt with new, the budget actually posted a small primary surplus for the first time since 2010.

The programme is committed to continued fiscal consolidation to lower debt-related vulnerabilities. The fiscal strategy foresees a significant reduction in the headline deficit of about 3.8 pps. in 2015-17, distributed equally over the three-year period. Specifically, the deficit, including expenses related to the clearance of arrears which are equivalent to 1.3 % of GDP in 2015 and 1 % in 2016, is expected to decrease to 3.9 % of GDP in 2015, 2.6 % in 2016 and 1.3 % in 2017. This is planned to be achieved by further raising the revenue-to-GDP ratio by 1.9 pps. to 27.8 % in 2015, and stabilising it at this level thereafter. Expenditure net of arrears clearance is also projected to increase in 2015 by 1.7 pps. to 30.4 % of GDP before falling back to 29.2 % of GDP in 2017.

Table II.1.3:

Composition of the budgetary adjustment (% of GDP)

	2013	2014	2015	2016	2017	Change: 2014-17
Revenue	24.0	25.9	27.8	27.8	27.9	2.0
- Taxes and social security contributions	19.3	20.9	21.8	22.1	22.3	1.4
- Other (residual)	4.7	5.0	6.0	5.7	5.6	0.6
Expenditure	28.9	31.0	31.7	30.4	29.2	-1.8
- Primary expenditure	25.7	28.2	28.4	27.3	26.2	-2.0
<i>of which:</i>						
Gross fixed capital formation	5.5	5.1	6.0	5.8	6.4	1.3
Consumption	9.0	8.7	9.0	8.6	8.2	-0.5
Transfers & subsidies	11.1	11.7	11.4	11.1	10.9	-0.8
Other (residual)	0.1	2.7	2.0	1.8	0.7	-2.0
- Interest payments	3.2	2.8	3.3	3.1	3.0	0.2
Budget balance	-4.9	-5.1	-3.9	-2.6	-1.3	3.8
- Cyclically adjusted	-4.4	-4.8	-3.9	-2.8	-1.6	3.2
Primary balance	-1.7	-2.3	-0.6	0.5	1.7	4.0
Gross debt level	70.1	71.8	71.6	68.8	65.6	-6.2

Sources: Economic Reform Programme (ERP) 2015, ECFIN calculations

The 2015 budget contains adjustments on the revenue side but also assumes sizable gains in tax collection. The expected increase in the revenue-to-GDP ratio for this year is of the same magnitude as in 2014, i.e. 1.9 pps. However, whereas last year's budget implemented revenue measures with a net positive impact of 1.5 % of GDP, in 2015 tax increases are estimated to yield additional revenues equal to only around 1 % of GDP.⁽¹⁾ Therefore, improved tax collection is assigned a much bigger role this year than in the previous one. Whereas the tax administration is planned to undergo wide-ranging reforms, including the on-going implementation of a new IT system to simplify processes, reducing opportunities for corruption and allowing for the reallocation of staff to audit and fraud investigations, a relatively strong reliance on them in budget planning carries risks which warrant close attention as well as steadfast implementation of the planned improvements. To contain risks, the budget comprises a contingency line equal to 0.3 % of GDP that will only be used if revenue performance is on track. The expected rise in tax revenues is projected to create some space for expenditure increases, especially higher investment and operating spending as well as increased interest payments.

Box: The budget for 2015

The parliament adopted the 2015 state budget on 27 November 2014. It assumes a GDP growth rate of 3 % and a decrease of the budget deficit to 3.9 % of GDP from 5.1 % recorded in 2014. The GDP deflator is expected to be 2.5 %.

The consolidation measures are focusing on the revenue side, but they remain below the adjustment implemented in 2014.

⁽¹⁾ See box for details on the impact of revenue and expenditure measures approved in the 2015 budget.

Table: Main measures in the budget for 2015 and their estimated net savings impact

Revenue measures*	Expenditure measures**
Increase in the withholding tax on interest, rent, dividend and capital gains from 10 % to 15 %. (0.3 % of GDP)	Reform of the disability system and reduction of unconditional transfers to local governments (0.1 % of GDP)
Increase in excise taxes on cigarettes and tobacco (0.3 % of GDP)	
Increase in the circulation tax on fuels (0.4 % of GDP)	
Total tax revenues effect (1 % of GDP)	Total expenditure effect (0.1 % of GDP)

* Estimated impact on general government revenues.

** Estimated impact on general government expenditure.

Source: ERP 2015

Beyond 2015, the programme does not foresee further revenue measures and aims instead to keep expenditure in check. The share of personnel expenditure is to decrease by almost 1 pp. compared with 2015 to 4.2 % of GDP, as the public sector payroll will be kept largely unchanged. Spending on operation and maintenance is also expected to decline in relative terms from 2.7 % of GDP in 2015 to 2.3 % in 2017, despite large unmet maintenance needs, especially in the road sector. The social assistance and disability benefit schemes are to undergo a revision to stamp out abuse and improve their targeting, which should reduce their combined share from 1.5 % to about 1.2 % of GDP. Within the expenditure envelope, public investment is the only major category that is expected to register a relative increase, from 6 % of GDP in 2015 to 6.4 % in 2017. However, in the recent past, delays in the execution of investments have meant that part of the initially-allocated budget could not be used.

Box: Alternative scenarios

In order to take into account some of the risks surrounding the baseline assumptions, the programme presents alternative scenarios in terms of growth and budget outcomes.

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 slower pace of tax efficiency gains is also part of the assumptions, whereas the baseline and favourable scenarios both count on tax collection improving to the same extent. In the low growth scenario, recovery is expected to be sluggish, with real GDP growth of only 1 % in 2015, 2 % in 2016 and 2.5 % in 2017, with a corresponding negative impact on revenues. Under this scenario, half of the revenue shortfall is offset by spending cuts,

exhausting the contingency line for deficit protection and reducing investment expenditure, while the rest increases the deficit (to 4.5 % in 2015, 3.5 % in 2016 and 2.5 % in 2017). This would lead to the public debt-to-GDP ratio standing at the same level in 2017 as in 2014. 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 be saved and thus used for deficit reduction.

Presenting alternative scenarios, even if they are relatively mild, 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 the main flexible item, i.e. capital spending. This underscores the need for sound public finances that preserve room for growth-enhancing expenditure.

Risks surrounding the medium-term fiscal path are well understood and partially internalised by contingency allocations. A largely dysfunctional energy sector exposes public finances to the costs of emergency imports of electricity in the form of direct support or state guarantees to the state-owned electricity company. While the sector is to undergo major reforms, changes will take time and vulnerabilities will remain significant for a while. The programme incorporates in its assumed debt trajectory, public guarantees to the electricity sector amounting to 1 % of GDP in 2015, 0.6 % in 2016 and 0.5 % in 2017 and commits to offsetting any additional support going beyond these amounts by budgetary adjustments of equal size. Another risk to the budget outlook is posed by the obligation, recently confirmed by international court rulings, to provide compensation for property expropriated during communism. While the amounts involved in currently-known claims for 2015 are not excessive and are fully budgeted, additional requests might surface and the whole scheme might need to be thoroughly reviewed to ensure its sustainability. Finally, some previously-committed public investments cannot be accommodated under the medium-term budget, which necessitates their prioritisation and the cancellation or rescheduling of low-ranking projects. To counterbalance a part of the fiscal risks, contingency lines with a total amount of 0.8 % and 1.5 % of GDP are foreseen in 2016 and 2017 respectively, most of which would affect capital expenditure.

The pension reform is largely implemented and addresses significant long-term risks. Despite Albania's youthful population, its pay-as-you-go pension system had been registering a growing deficit (around 1.8 % of GDP in 2012) and risked becoming unsustainable as a result of a combination of compressed benefits creating disincentives to contribute and declare total earnings, ad hoc pension increases exceeding inflation, and a highly subsidised rural pension scheme. The pension reform, whose main elements entered into force in January 2015, addresses these weaknesses by gradually raising the retirement age, phasing out the subsidised rural pension scheme, linking the minimum contributory wage to the minimum wage, reinforcing the contributory principle by removing the ceiling for maximum pensions and indexing pensions to inflation. At the same time, a means-tested social pension has been introduced to provide modest benefits for the vulnerable without coverage. As a result of these changes, and depending on the extent to which contributions increase, the deficit of the pension system is expected to decline from 1.4 % of GDP in 2015 to 1.1 % in 2017 and further to 0.8 % in 2020.

The high level of public debt and its short-term bias remain a key source of macroeconomic risk but fiscal adjustment is expected to start lowering it. Albania's debt level, at more than 70 % of GDP, exposes the country to the risk of explosive debt dynamics in the event of large adverse shocks. This vulnerability is also reflected in the high risk premia on state borrowing which affects the interest rates faced by businesses. Lowering the perceived riskiness of holding government debt could therefore have a positive impact on the real economy. However, risks are exacerbated by the fact that almost half of domestic debt is short-term, resulting in the need to roll-over every year debt worth about 20 % of GDP while relying on a narrow investor base composed mainly of domestic banks. Moreover, even though much of Albania's external debt, which amounts to 29.1 % of GDP, is on concessional terms, it is subject

to exchange rate risk. The programme is fully aware of these risks and is committed to addressing them. Fiscal consolidation and the resurgence of growth are expected to start lowering the debt-to-GDP ratio this year, and the programme sets the objective of decreasing it to less than 66 % in 2017 and below 60 % by the end of 2019. The debt management strategy aims over the medium term to lengthen the maturity profile of debt, reduce the reliance on floating rates, develop the secondary market and expand the investor base, as well as keep external debt in check. In the short term, Albania plans to use a World Bank guarantee to expand external borrowing, thereby relieving the domestic market and facilitate the revival of lending to the economy. A significant test of whether Albania's efforts to improve its fiscal credibility are bearing fruit will be the refinancing in 2015 of its existing eurobond with an amount of at least EUR 300 million.

Table II.1.4:

Composition of changes in the debt ratio (% of GDP)					
	2013	2014	2015	2016	2017
Gross debt ratio [1]	70.1	71.8	71.6	68.8	65.6
Change in the ratio	7.6	1.7	-0.2	-2.8	-3.2
<i>Contributions [2]:</i>					
1. Primary balance	1.7	2.3	0.6	-0.5	-1.7
2. "Snow-ball" effect	1.9	0.4	-0.4	-1.5	-1.8
<i>Of which:</i>					
Interest expenditure	3.2	2.8	3.3	3.1	3.0
Growth effect	-0.8	-1.4	-2.0	-2.7	-2.9
Inflation effect	-0.5	-1.0	-1.7	-1.9	-1.9
3. Stock-flow	4.0	-1.0	-0.4	-0.8	0.3

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 Reform Programme (ERP) 2015, ECFIN calculations

Public finance management is poised to get a major overhaul. With weak multi-year commitment control and budget planning, overoptimistic growth and revenue projections, as well as politically motivated overspending and lax tax collection in election years, public finance management has been a weak spot for many years. It has contributed to a continuous increase in public debt and the accumulation of large government arrears owed to businesses for goods and services provided and for tax refunds. It has also hindered the efficient management of capital investments. To address these weaknesses, the programme refers to the recently-approved public finance management strategy which will run until 2020 and will also get EU support from IPA. Among others, it contains plans to make multi-year budgets more binding and strengthen commitment control in the short term. It also expects to introduce rules to limit political expediency in spending and eliminate systematic biases in budget forecasts. Fiscal credibility is to be reinforced by adopting a fiscal rule in the short term, whose design should obviously draw some lessons from the failure of the previous rule whose debt ceiling of 60 % of GDP was breached and eventually abolished in 2012. Revenue management is also to be strengthened and a fiscal cadastre of properties established, laying the foundations for a new property tax. Overall, the plans are certainly ambitious and implementing them would hugely contribute to anchoring longer-term expectations about public finances in Albania.

1.4. STRUCTURAL REFORMS

Raising long-term growth prospects requires structural reforms. The programme concisely, but correctly, identifies the main obstacles to growth as: weaknesses in the rule of law and the business environment; a high degree of informality; structural problems in the energy sector; and labour market failures including skills gaps resulting in high unemployment. The remedies proposed to address these weaknesses, although useful, differ in their degree of ambition and their level of detail. Some of the identified deficiencies, such as those related to strengthening the rule of law or fighting informality, get little mention in the envisaged measures. Overall, however, and taking also into account the public finance-related measures described above, the programme reflects a clear momentum for reforms which should be seized and sustained.

The business environment is to be improved through enhanced dialogue with the business community and regulatory changes. The government has replaced the previous advisory body with a much stronger National Economic Council, comprising various business associations, state institutions and academics and featuring the Prime Minister as chair; it is tasked with advising the government on ways to improve the legal and institutional framework relevant for businesses. Its regular meetings have served as a platform to discuss the budget proposal and the ongoing clearance of arrears, as well as to draw attention to arbitrary administrative practices and corruption. This high-level forum is expected to be complemented by setting up an Investment Council at a more technical level. Besides efforts to improve communication with businesses, Albania has also created inter-ministerial working groups focusing on key regulatory aspects, such as resolving insolvency, paying taxes, or registering property. Measures taken so far have been reflected in the improvement of Albania's position in some international business climate rankings, but there remains ample scope for further progress.

Large-scale privatisation is virtually complete. Therefore, efforts are focusing on state-owned small and medium-sized enterprises in non-strategic sectors. According to the revised privatisation strategy, companies with poor economic performance will go into liquidation, while the unused assets of remaining ones will be offered for lease to domestic and foreign investors. Minority stakes in smaller companies will also be auctioned. As regards the limited remaining state ownership in strategic sectors, external technical assistance has been sought to identify the best option for the oil company AlbPetrol out of possibilities ranging from an outright sale to concession or joint venture.

The electricity sector is a major arena for reforms. This is well warranted by the scale of the problems. Albania's electricity supply is almost entirely dependent on volatile hydropower, while generation capacity is hard pressed to meet growing demand. A largely dysfunctional market relies on the state to pay for emergency power imports in the context of staggering distribution losses due to theft, tariffs below cost-recovery level, inadequate bill collection and widespread arrears. In a no-change scenario, the annual financial gap of the sector was previously estimated to be at least 1.5 % of GDP. The government has already taken some tough measures such as tightening criminal penalties for electricity theft, launching a campaign to clamp down on illicit connections to the grid and adjusting tariffs. It has also secured a USD 150 million loan from the World Bank that will enable investments in distribution and the metering of consumers as well as upgrades to the commercial billing and collection system. In addition, a draft new power sector law has been prepared that will restructure institutional relations within the sector and move towards further market liberalisation by 2017. As an early sign of progress, distribution losses fell to 35 % in October 2014 from 45 % a year earlier. The programme commits to further reducing them by 5 percentage points per year, to 15 % by 2019, and to improving the bill collection rate from 83 % in 2014 to 93 % by 2019, in particular by ensuring that public institutions remain current on their bills. These efforts will be supported by a restructuring of state electricity companies, including through a performance management contract for the recently renationalised distributor. However, as the programme also acknowledges, a deep reform of this strategic sector needs time as well as considerable financial resources.

Financial sector oversight is expected to improve further. The Bank of Albania has taken steps to enhance risk-based supervision and has also sought to improve crisis preparedness by introducing the requirement for systemic banks to adopt recovery plans. As regards the non-banking sector, the programme recognises the need to reinforce the regulatory framework for investment funds, whose popularity and assets have steadily increased since their creation in 2011 without a corresponding strengthening of their oversight. The Financial Supervisory Authority has already introduced capital adequacy requirements for them and plans to adopt rules on minimum liquidity as well as asset valuation by mid-2015.

Addressing labour market imbalances remains a substantial challenge. Labour force surveys, even if suffering from methodological weaknesses, indicate a high rate of unemployment, which peaked at 18.6 % in the first quarter of 2014 and has slightly come down since. The programme expects it to fall further, to 13.9 % in 2017, on the back of a projected recovery in the most labour intensive sectors, including agriculture, textiles, footwear and tourism. Still, the very high prevalence of youth unemployment, large gender differences in labour force participation and the high proportion of subsistence farmers in agriculture point to enduring structural weaknesses. A National Employment and Skills Strategy for the period 2014-2020 was approved at the end of 2014 and aims to overhaul active labour market policies, improve vocational education and training, reform social safety nets and strengthen the governance of the labour market. The reform of vocational education has started with institutional changes, expected to be followed by the introduction of an apprenticeship system and upgrades to the curricula in line with market needs. The reform of the employment service system is also underway and new employment offices are being opened in the most problematic areas, which should be adequately staffed and funded. The fund earmarked for supporting active labour policies tripled in size in 2014 and will double again in 2015, but it will still reach only a fraction of those in need. Due to the fund's still limited size, it will be especially important to ensure that its resources are spent efficiently, including through rigorous ex-post evaluations of the support it gives.

Health and local government reforms aim to increase efficiency and rationalise spending. Albania's public health spending is low at around 2.3 % of GDP but health outcomes are decent. As fiscal space will not allow a noticeable increase in spending in the coming years, the focus will be on improving efficiency, notably through an increased role for the Health Insurance Fund as a strategic purchaser of health services. Following the submission of the programme, Albania has also secured World Bank financing to support reforming of the hospital sector, improving the monitoring and management of service quality and efficiency through the establishment of a health management information system, and reforming the health financing system. Local government reform got a boost from the Parliamentary approval in June 2014 of a new law which will, after local elections scheduled for mid-2015, reduce the number of local government units from 373 to 61, generating savings estimated at about 0.2 % of GDP annually. In addition, a new decentralisation strategy is in the making, which aims to devolve a number of functions to the local level without endangering fiscal sustainability.

1.5. IMPLEMENTATION OF THE 2014 POLICY GUIDANCE

Albania has made good progress in several areas highlighted in the Commission's policy guidance laid out in Vice-President Rehn's letter of 30 June 2014. In particular, revenue performance in 2014 was commendable, thanks also to improved tax administration. Fiscal consolidation remains centre stage and current projections assume that the debt ratio will start declining in 2015. The agreement on a new fiscal rule is envisaged in the short term, although its adoption still faces important hurdles. The bulk of the pension reform was successfully completed ahead of schedule. The energy reform also moved up the policy agenda and first steps have been taken to start addressing the most glaring weaknesses. The regulatory business environment has improved, as confirmed by recent international rankings, which however also highlight significant remaining weaknesses.

On the other hand, there has been little progress on property rights and the overgenerous scheme for property compensation is still to be reviewed in light of the available fiscal space. A prioritisation of existing investment commitments to meet budget constraints is also outstanding. NPLs remain elevated which underscores the need for further efforts to clean bank balance sheets. Last but not least, the bulk of the envisaged reform of vocational training still remains to be done.

Box: Implementation of the 2014 Policy Guidance

The following is a short assessment of the main measures taken or planned to be taken by Albania in response to the policy guidance provided in Commission Vice-President Rehn's letter of 30 June 2014. The guidance was based on the Commission's assessment of Albania's previous medium-term programme for 2014-2016, submitted in January 2014.

1. *Enhance macroeconomic stability by putting the public debt-to-GDP ratio on a downward path as from 2015, and bring it down to around 69 % of GDP by 2016 from around 72 % in 2014; in this context, preserve the fiscal space for growth-enhancing public investment; take concrete steps towards adopting a quantitative fiscal rule which will effectively ensure the sustainability of public debt in the long run.*

- The 2015 budget and the medium-term framework contained in it comply with this debt trajectory. In the baseline scenario presented in the ERP, the level of capital expenditure is kept at around 5 % of GDP per year (although this includes a contingency line which could be scrapped in case of budget underperformance).
- The PFM Strategy approved by the Government at the end of 2014 foresees the establishment of a fiscal rule, to be approved by the Parliament with a qualified majority still in 2015.

2. *Strengthen the efficiency of tax administration and tax collection, implement budgetary mechanisms which will prevent the accumulation of arrears in the future, and prioritise public investment projects on the basis of cost-benefit evaluations.*

- A new tax administration IT-system, which will simplify processes and reduce opportunities for fraud and corruption, is being implemented.
- Responsibility for VAT refunds has been transferred from the tax administration to the Treasury while the new VAT law, adopted in July 2014, foresees a risk-based audit of refunds as from June 2015 instead of a time-consuming compulsory one.
- A lottery based on fiscal coupons is being set up to encourage the request of receipts. The first draw is expected in April 2015.
- A fiscal cadastre will be established to lay the foundations for a new property tax.
- Coordination between the tax and customs administrations is being strengthened by making their IT systems compatible with each other and conducting joint controls and audits.
- Some safeguards have already been put in place to prevent arrears accumulation, such as a compulsory prior Treasury approval for all procurement orders. Multi-year limits for investment projects and other long-term commitments were enacted with the Law on the budget for 2015.

3. *Implement a reform of the pension system: adopt, as a first step, a strategy with the aim of ensuring the sustainability of the scheme in the long run as well as the required amendments to the existing*

legislation.

- The pension policy paper was drafted and discussed with experts and stakeholders during 2014. The main elements of the pension reform, aiming to ensure the long-term financial sustainability of the scheme, were approved by the Parliament in July 2014
4. *Pursue measures in the energy sector aimed at reducing losses and improving bill collection, and take steps towards reforming the sector in order to improve its financial position and eliminate high risks it poses to public finances.*
- A draft new power sector law have been prepared and submitted to Parliament at the end of 2014. It will restructure relationships between the three public power companies responsible for generation, transmission and distribution and will also proceed towards further market liberalisation by gradually moving all medium voltage consumers out of the regulated tariff structure by end-2018. The draft law also clarifies the full independence of the energy sector regulatory authority (ERE).
 - ERE approved new regulated tariffs that came into force in January 2015. The household retail tariff was restructured by eliminating the subsidised lower block which was open to abuse. At the same time, an increase in the average tariff for commercial users was approved. ERE plans to move in the direction of more frequent and automatic tariff adjustments based on market pricing.
 - A campaign was launched in October 2014 to enforce criminal penalties for electricity theft and disconnect service for non-payment of bills. The criminal code has been revised to make power theft punishable by imprisonment. The government has pledged to ensure that public institutions make timely payments of electricity bills.
5. *Improve the overall business environment, in particular by simplifying and enhancing the predictability of the regulatory business environment, such as procedures for business registration and construction permits. Make progress in the area of property rights, in particular by speeding up the completion of first registration of properties and by reviewing the compensation policy with the aim of creating a realistic, transparent and sustainable framework for compensations.*
- The National Economic Council has been established as a reinforced advisory body for the government, including representatives from the business community, key ministries and multilateral partners. Steps are being finalised to create an investment council funded by the EBRD.
 - An inter-ministerial working group has been created to implement ‘Doing Business’ reforms and devised ways to improve rules pertaining to paying taxes, starting a business, accessing electricity and registering property. The work continues in 2015.
 - An action plan on the reform of the property compensation scheme will be finalised by June 2015. A working group, headed by the Deputy Prime Minister, is operating to evaluate the total cost of compensation claims and identify possible financial resources. Following a recent government decision, ownership of state-owned land has been transferred from local governments to the restitution fund.
6. *Together with the Bank of Albania and all other relevant actors, take all the necessary measures to address the issue of non-performing loans with a view to achieving a sustainable reduction of their level.*
- Bank of Albania has adopted regulatory amendments aimed at encouraging banks to undertake early

loan restructuring.

- Following changes to the income tax law, the central bank has amended its regulation on credit risk management, requiring banks to write off all loans that have been classified in the ‘loss’ category for more than three years. The obligation came into force in January 2015.
7. *Implement measures aimed at improving education and vocational training outcomes and address mismatches in skills demand and supply.*
- An overall reform of vocational education and training is underway. As a first step, responsibility for vocational schools has been transferred to the Ministry of Social Welfare and Youth. This will be followed by the introduction of an apprenticeship model according to which students spend at least 30 % of their classes at local businesses. To narrow the gap in skills demand and supply, a study will assess private sector needs for employer qualifications and vocational training. The results will feed into devising new curricula and opening new education programmes.
 - In 2014 the fund supporting active labour market measures tripled in size in 2014 and it will double again in 2015. It is expected that in 2015 at least 5 000 unemployed jobseekers will be employed through this programme.

1.6. THE 2015 POLICY GUIDANCE

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning part I of the ERP, Participants hereby invite Albania to:

1. Pursue fiscal consolidation in line with the objective to put the public debt ratio on a downward path and lower it to less than 66% of GDP by 2017. At the same time, preserve fiscal space for growth-enhancing public investment by making sure that revenue performance remains on track, allowing for the initially budgeted capital expenditure to be executed.
2. Progress towards eliminating high fiscal risks posed by the electricity sector by reducing distribution losses at an average rate of 5 percentage points in the coming years and by improving the bill collection rate. Evaluate the fiscal impact of the property compensation scheme and accommodate the costs in the medium-term budget, if necessary by adjusting the parameters of the scheme with the aim of creating a realistic, transparent and sustainable compensation framework.
3. Reinforce the budget management framework by implementing the public finance management strategy agreed with the Commission and adopted in December 2014, in particular by moving towards adopting a credible fiscal rule which will effectively ensure the sustainability of public finances in the long run and by strengthening budget forecasting.
4. Take further measures to address the issue of non-performing loans, involving all key stakeholders including the Bank of Albania as necessary, with a view to achieving a sustainable reduction of their level. In this context, addressing impediments related to judicial enforcement and collateral

execution would appear helpful.

Concerning part II of the ERP, Participants invite Albania to:

5. Adopt and start to implement the law on higher education, as well as the new strategy for higher education. Establish an independent accreditation system for all public and private universities. Continue the restructuring of the VET system with a view to improving the relevance of the training for the needs of the labour market.
6. Improve the overall business environment, including by implementing the merger of the NRC (National Registration Centre) and NLC (National Licensing Centre) to further ease the regulatory and administrative burden for businesses. Start the implementation of the simplification regime for authorisations. Make the newly established investment council fully operational.
7. Adopt and start to implement the transport strategy and action plan for 2016-2020. Focus investments on the core network. Adopt and start to implement the national energy strategy and the Power Sector Law, including speeding up the unbundling of the energy sector. Prepare single sector pipeline of priority investments for both transport and energy.
8. Adopt a strategy on the land cadastre and concrete measures to increase momentum in agricultural land consolidation.

Annex: Overall assessment of programme requirements

Albania's Council of Ministers approved the programme on 28 January 2015 and submitted it to the European Commission on 30 January 2015. The programme is in line with the annual budget for 2015 and the Macroeconomic and Fiscal Framework 2016-2018. It was prepared by an inter-institutional working group with representatives and experts from relevant institutions of the Albanian government and the Bank of Albania. The programme is consistent with the assessments contained in the 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 labour market and wage statistics. The macroeconomic framework is sufficiently comprehensive and its presentation has improved compared with last year's programme; links between the macroeconomic and fiscal assumptions and the structural reform measures have also been made more explicit. Efforts have been made to improve the analysis of the country's external position, notably through performing stress tests for the evolution of external debt. However, the analysis could be improved further, for instance through an enhanced assessment of Albania's net international investment position and a reference to cost competitiveness indicators.

Fiscal framework

The fiscal framework is detailed and well integrated with the policy objectives. It is also consistent with the presented macroeconomic framework. The budgetary impact of envisaged measures could have sometimes been made clearer. The programme complements the baseline assumption with somewhat mild alternative scenarios and their impact on the budget. For the first time, it also contains estimates of the output gap and the structural budget balance, even if caveats are well warranted due to data limitations. Fiscal data are not in full compliance with ESA95/ESA2010 standards and deviate from the fiscal notification submitted by Albania for the first time in November 2014.

Structural reforms

The structural reform framework is more coherent, consistent and streamlined than a year earlier. Some challenges that are identified as being among the main obstacles to growth are however left unaddressed by the proposed measures. The presentation of some reforms could have been more strategy-driven and clearer.

2. THE FORMER YUGOSLAV REPUBLIC OF MACEDONIA

2.1. EXECUTIVE SUMMARY

Carried by a surge in public and foreign direct investment, and by a marked pick-up in exports, the economic recovery of the Former Yugoslav Republic of Macedonia strengthened in 2014. Annual output growth accelerated to an estimated 3.8%, from 2.7% in 2013. The government expects growth to strengthen gradually until 2017, with output increasing on average by nearly 4.3% annually, in real terms. Rebalancing towards domestic demand should progress, as private consumption strengthens, and the annual growth of investment and exports declines to more moderate and steady levels. The external balance is projected to remain a drag on growth throughout the programme, with import growth likely to remain solid against a background of large public infrastructure investment plans and the pick-up in household spending. The authorities expect employment growth to accelerate between 2015 and 2017 to an average of 3% a year, up from 1.3% in 2013. Price pressures are projected to increase in 2015-2017, on account of external factors, ending the marked deflationary environment of 2014. External imbalances are seen increasing slightly in 2015 and 2016, as private transfers decline and the primary income balance deteriorates, but would narrow thereafter as the trade balance improves.

Fiscal discipline disappointed again in 2014. Revenue underperformance in the first half of the year, and spending pressures from frontloaded pre-election transfer and subsidy payments, forced the government to adopt a supplementary budget in September, raising the general government budget deficit from 3.5% to 3.7% of GDP. However, eventually even the revised target was exceeded by some 0.5pp. This raises doubts about the programme's fiscal assumptions, which are based on the September 2014 medium-term fiscal strategy. Compared to the previous year's strategy, the latter foresees a relaxation of the fiscal consolidation path, revising upwards the 2015-2017 budget targets. It envisages a reduction of the general government deficit from 3.3% in 2015 to 2.9% by 2017, mainly through faster growth in revenues than in expenditure. After a slight drop in 2015, general government debt is expected to increase again, gradually, before stabilising. This fiscal scenario relies on somewhat optimistic revenue expectations, which could create pressures for a supplementary budget mid-year. Hence, stabilisation of the government debt ratio could take longer than foreseen by the authorities. Debt sustainability might require further consolidation efforts beyond 2017 and a more rigorous management of state guarantees on debt contracted by state-owned enterprises, through which an increasing part of public infrastructure investment projects are channelled.

The government correctly assesses the key challenges to growth and employment and the related structural reforms. As in previous years, it stresses the importance of enhancing the competitiveness of the domestic economy by developing the private sector; combatting unemployment, in particular by better matching skills with demand; improving the management of public finances; and, safekeeping financial stability. It maps out a number of adopted and planned measures. However, a great number of these remain largely conceptual. Implementation of structural reforms in key areas has been slow, in particular regarding labour market policies and education reform. Regulatory reform targeting the competitiveness of the domestic business sector, has been lagging and links between foreign and local companies remain sparse.

2.2. ECONOMIC OUTLOOK AND RISKS

Economic growth is expected to strengthen further. Strong export activity, public infrastructure projects and foreign direct investment underpinned the acceleration of output growth in 2014. Annual real GDP increased by an estimated 3.8%, compared to 2.7% in 2013. Output gains were particularly strong in

manufacturing, which accounts for about three quarters of the industry structure. The authorities expect domestic demand to remain the sole pillar of economic growth in 2015 and 2016. The drag from the external balance should diminish, as the deficit in the merchandise balance is expected to narrow. Imports growth is nevertheless expected to remain elevated on account of further firming domestic demand, including investment-related needs of new foreign investment. Household spending would increase gradually and at an accelerated pace, in line with assumptions for a steady rise in net wages, aided by a benign inflation environment; further strengthening of credit extension; and, stable private transfers from abroad.

Table II.2.1:

Macroeconomic developments and forecasts										
	2013		2014		2015		2016		2017	
	COM	PEP	COM	PEP	COM	PEP	COM	PEP	COM	PEP
Real GDP (% change)	2.7	2.7	3.5	3.7	3.5	4.0	3.6	4.2	n.a.	4.5
<i>Contributions:</i>										
- Final domestic demand	-1.9	-2.8	5.1	5.0	4.8	4.9	4.7	5.0	n.a.	5.5
- Change in inventories	-0.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	5.6	5.5	-1.7	-1.3	-1.4	-0.8	-1.0	-0.8	n.a.	-1.0
Employment (% change)	4.3	4.3	2.0	2.5	2.2	2.7	2.3	3.0	n.a.	3.2
Unemployment rate (%)	29.0	29.0	28.5	28.0	27.5	27.0	26.4	25.9	n.a.	24.8
GDP deflator (% change)	4.3	4.3	0.2	1.7	0.8	1.0	1.3	1.5	n.a.	1.7
CPI inflation (%)	2.8	2.8	0.8	-0.3	1.3	2.0	1.7	2.2	n.a.	2.2
Current account balance (% of GDP)	-1.8	-1.8	-2.0	-2.7	-2.4	-3.9	-2.2	-4.6	n.a.	-4.1
General government balance (% of GDP)	-3.9	-4.0	-3.9	-3.7	-3.5	-3.3	-3.2	-3.2	n.a.	-2.9
Government gross debt (% of GDP)	34.2	34.1	38.0	37.7	39.1	35.5	40.1	37.3	n.a.	38.7

Sources: Economic Reform Programme (ERP) 2015, Commission 2015 Winter Forecast (COM)

Authorities' growth expectations are slightly optimistic. The programme's growth scenario is broadly in line with the Commission's winter forecast as regards the main growth drivers, yet the extent of the expected expansion of domestic demand may be overestimated. For one, the projected rise in total investment depends largely on the actual implementation of the significant pipeline of public investment projects. Public investment projects that are financed through the government's capital expenditure budget are prone to mid-year adjustment to the benefit of previously underestimated current expenditure obligations, and to under-execution. Secondly, net exports may detract more from growth than foreseen by the programme. Export activity is mainly driven by a few foreign direct investors, with a large number of uncompetitive domestic companies in the tradable sector suffering from low labour productivity. The diversification of the export structure into higher-value added products is making slow progress. Also, the pipeline of investment in new or extended foreign facilities in the country in 2015 and 2016, as well as the highly import-dependent production activities of some foreign firms may impact more than expected on the trade balance. Despite the recent increases in pensions and social transfers, and plans for more, private consumption expenditure could grow more slowly than foreseen in the programme, as disposable incomes are not expected to rise significantly. This is because overall compensation growth is sluggish; renewed, though moderate, price pressures are weighing on real net wage developments; and, private transfers from abroad are expected to relent. As a result, economic growth may well increase by less than expected in the programme.

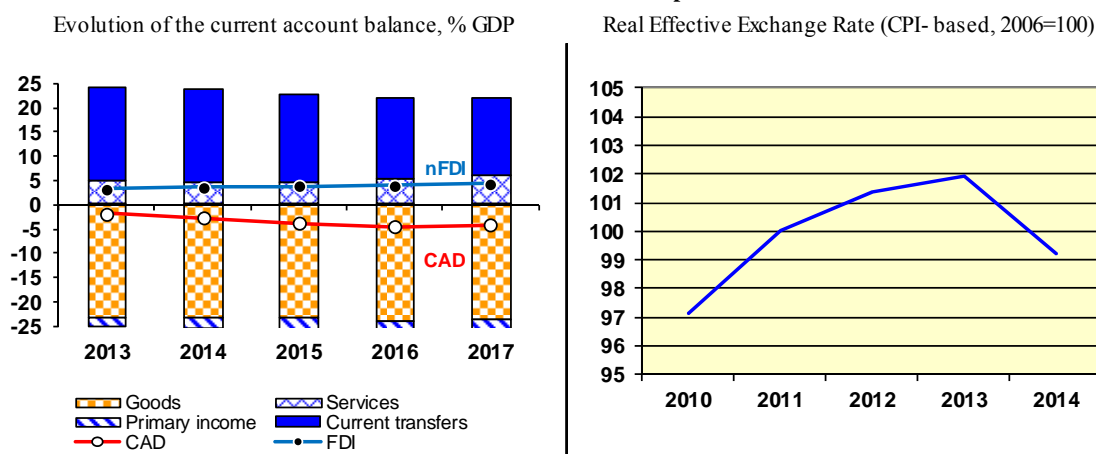
Reliance on transfers for financing the external balance remains a key vulnerability. On account of a lower merchandise trade gap, higher private transfers, and in spite of a widening deficit in the primary income balance, the current account deficit narrowed in 2014 by more than 20%. It amounted to an estimated 1.3% of GDP in 2014, compared to 1.8% in 2013. After slight improvement in 2015, in annual terms, the authorities expect the current account deficit to widen markedly in 2016, to 4.6%, and to narrow again thereafter, when the improvement in the trade balance should outweigh the negative impact of a further widening primary income deficit. Private transfers amounted to about 19% of GDP on

average over the past five years, and covered almost 95% of the merchandise trade deficit. The programme assumes a gradual decline in the importance of private transfers to their long-term average of about 16% of GDP by 2017. Current account financing may thus depend increasingly on foreign direct investment, on the one hand, and on increased external borrowing by the government, on the other hand. FDI remains low and volatile. It accounted for some 3.3% of estimated GDP in 2014, almost unchanged from 2013. The government projects FDI inflows to gradually increase to 4.3% of GDP in 2017. Foreign borrowing by the government and by public enterprises has become the main driver of foreign exchange reserve developments. The external debt of the public sector exceeded central bank reserves by some 12% at the end of 2014. With foreign reserves having declined towards the end of 2013 and in the first half of 2014, due to weak financial account inflows and negative valuation effects, it was mainly the increase in government debt over the summer – a 500 mio Eurobond in July - that boosted reserves again during the second half of the year.

External debt is set to rise further. Mainly on account of the government's external borrowing, gross external debt of the economy rose by 7pp in 2014 to some 71% of estimated GDP. The share of external debt in total general government debt increased by some 6pp to 64% of GDP in the same period. Other indicators of indebtedness, such as debt servicing to exports, and interest repayment to exports, continued to suggest low external indebtedness of the country. Early repayment of IMF loans due in 2015 and 2016 at the end of February 2015 partly offset the earlier increase in external debt levels and in reserves. However, projections point towards a further increase in external debt levels over the next years, given the elevated financing needs of state-owned enterprises managing public infrastructure projects, which are likely to be met by foreign commercial loans. In addition, the government's debt management strategy foresees that fiscal deficits as of 2015 would be financed by external borrowing, with recourse to domestic borrowing for maturing local currency debt only. Meeting the medium-term stabilisation targets of external debt envisaged by the authorities may thus prove a challenge, which is increased by the marked sensitivity of external debt levels to negative developments on the primary current account.

Graph

Current account and external competitiveness



Source: ERP 2015, ECFIN services

Gradually tightening price pressures stem from external factors. Lower prices for food – which account for over 40% of the country's consumer price index structure – and for energy led the CPI into negative territory in 2014, decreasing by 0.3% on average, compared to an increase of 2.8% in 2013. The government realistically assumes a slight acceleration of price increases over the medium-term horizon, to reach 2% in 2017. This would be mainly on account of external factors, as the downward trend in oil prices is expected to come to a halt, prices for food and some commodities will be on the upturn again. While recent changes in regulated prices might produce second-round effects on other domestic prices,

and electricity prices might be raised in 2015, authorities see no pressures arising from firming domestic demand.

The expected growth in output may have only limited impact on the labour market if structural reforms are not implemented. The programme assumes a gradual acceleration of employment growth between 2015 and 2017, amounting to an annual 3% on average. The unemployment rate would fall gradually from 28% in 2014 to 24.8% by 2017. This scenario is more optimistic than last year's programme and than the Commission's projections. It is subject to downward risks arising, generally, from the historically weak link between output and employment growth, which points to structural impediments such as skills mismatches and low worker mobility between sectors and regions. In addition, specific risks stem from uncertain implementation of public and foreign direct investment plans.

The alternative scenario fails to take into account downside risks to domestic demand. The authorities present an alternative macroeconomic scenario based on weaker external demand from the main trade partners. This should lower real GDP growth in the country by 1.3pp in each of the years 2015-2017, 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, which could come from delayed implementation of structural reforms, rather than restricting the analysis to external risks, particularly since the growth assumptions for trade partners underlying the programme's baseline scenario seem fairly realistic.

The banking sector remains resilient and further reduces reliance on foreign funding. Supported by their strong domestic funding base and modest interlinkages with international wholesale funding markets, the country's commercial banks continued to stay their course. The sector's profitability improved, with both, return on assets and return on equity having risen markedly since the summer. Solvency and liquidity indicators remained stable. Regulatory capital levels in the sector have remained solidly above the minimum threshold prescribed by international capital requirements rules, and the share of liquid assets in total assets is comparatively high. Funding risk remains contained, as domestic banks derive an increasing share of their financing from domestic deposits, thus further reducing their reliance on foreign funding, and mitigating their balance sheet risks by a better currency alignment of assets and liabilities. However, the sector's credit risk remains important, as the quality of bank loan portfolios has not improved. At the end of the fourth quarter of 2014, non-performing loans accounted for 11.3% of gross loans to the non-financial sector, only slightly down from a year earlier. Even though the ratio of banks' total provisions to NPLs declined gradually in 2014 – possibly explaining some of the pick-up in profitability – provisions still cover the stock of NPLs.

Monetary policy supported the gradual recovery of bank lending throughout 2014 and is changing to a neutral stance. The central bank remained committed to maintaining a stable exchange rate of the denar against the euro, and to preserving price stability. While continuing to support output and credit growth through non-standard measures, and following a series of reductions in key interest rates, it kept the key policy rate unchanged in 2014. In order to encourage loans to net exporters and domestic electricity producers, the central bank extended the reduction of reserve requirements for new loans to these sectors in September 2014 until the end of 2015. As of the beginning of 2014, it stopped paying remuneration on banks' reserve requirements. The central bank continued to encourage the use of the domestic currency on both sides of the balance sheet, by keeping the spread between reserve requirements on banks' domestic and foreign currency liabilities. Bank lending to the private sector has strengthened gradually since 2013. While the bulk of credit growth initially went to households, lending to non-financial companies picked up significantly in 2014, albeit with a significant share of new funding bolstering liquidity rather than new investment. Generally, banks' credit standards remain tight in spite of ample liquidity. With expectations of firming domestic demand and credit growth, and assuming that external imbalances remain contained, monetary policy is likely to remain neutral for the time being.

2.3. PUBLIC FINANCE

Fiscal discipline deteriorated yet again in 2014. Revenue outcome disappointed in the first half of the year, forcing the government to adopt a supplementary budget in mid-year. This provided for an increase in the general government deficit target for 2014 by 0.2pp compared to the original target, to 3.7% of GDP. The budget revision lowered revenue projections and cut total spending by 0.8%, with the bulk falling on capital expenditure. Yet, at 4.2% of estimated GDP, the actual deficit outcome still exceeded the revised target, by 0.5pp, as both, tax and non-tax revenue for the year remained even below the revised expectations, while the government had further raised some transfer payments as well as public wages in the course of the year. Overall, revenue for the year remained some 8% below the original projection.

There is ample room for improving the composition of spending. The general government budget continues to be heavily dominated by entitlement spending, reducing the room for fiscal contingency planning manoeuvre in case of disappointing fiscal outcomes. Social transfers including pensions account for some 45% of total budgeted spending. The share of capital expenditure in total general government expenditure remained, again, modest in 2014, at 10.5%, and slightly below pre-year level (this does, however, not take into account public infrastructure projects financed by the Public Enterprise for State Roads). In terms of GDP, capital expenditure remained relatively low in 2014, at some 3.4%, and below its 2013 level. Moreover, budgeted capital expenditure was again under-implemented - only about 83% of the revised budgeted amount was executed, a similar underperformance as in 2013. The share of current expenditure in GDP, on the other hand, increased somewhat compared to 2013, to 29.3%. In 2014, the government boosted pensions, like in 2013, by an additional 2% on top of the 3% annual inflation-indexed rise. Public sector wages were increased by 5% beginning in October 2014, again as in the preceding year, and agricultural subsidies, providing income support to farmers, were also raised.

The 2015 budget is again based on over-optimistic assumptions. The macro framework underpinning the 2015 budget – assuming 4% real GDP growth - appears overly optimistic, leading to a likely overestimation of public revenue. The authorities expect total general government revenue, on the assumption of no changes in tax policies, to increase by almost 20%, in nominal terms over the 2014 outcome. Given that the 2014 deficit exceeded even the revised target, the envisaged reduction of 0.9pp to 3.3% of GDP in 2015 seems difficult to achieve without further consolidation measures.

New current expenditure commitments are likely to jeopardise the implementation of capital spending. The authorities plan to increase capital expenditure in 2015 by 0.4pp to 3.8% of GDP, compared to the 2014 outcome. However, since 2006, the actually realised capital spending has been on average some 25% below initial plans. Moreover, it has frequently fallen victim to mid-year budget reviews in response to revenue shortfalls. Recent and future anticipated increases in entitlement spending and in public wages limit the authorities' flexibility for cuts in current expenditure. Moreover, the government assesses fiscal space in the course of the year and decides on further ad hoc raises in transfers, subsidies and public wages - in March 2015, it announced a rise in social transfers by an additional 5% as of June 2015. In particular the implementation of capital projects with a significant potential impact on economic growth is put at risk also by the lack of clear prioritisation among the multitude of donor- and budget-financed projects, and of regular and timely information on the state of implementation of projects.

Fiscal consolidation plans and government debt stabilisation are delayed. The fiscal strategy for 2015-2017, adopted in September, foresees a relaxation of previously fixed mid-term government budget deficit targets. The general government deficit ratio is now expected to fall below the 3% target, which the government is planning to anchor in the constitution, by 2017 only (2.9% of GDP), compared to the previous baseline scenario of 2.6% in 2016. 2017 would also be the first year of the application of the new constitutionally anchored deficit ceiling, hence leaving little room for contingency adjustments. Overall, in line with the 2014 fiscal strategy, the programme envisages a primarily revenue-based

reduction of the general government deficit from 3.7% in 2014 (which was most likely exceeded by some 0.5 pp) to 2.9% of GDP in 2017. The revenue ratio is projected to fall by 1.4pp to 30.2% of GDP in 2017. The total expenditure ratio is expected to decline by over 2 pp, from 35.4% to 33.2% of GDP, during this period. Allocations for the main current expenditure items - social transfers, subsidies, and collective consumption are expected to decline, as a share of GDP, over 2015-2017. The fiscal stance, as measured by the cyclically-adjusted balance, was marginally tightened in 2014, according to government calculations. It is projected to become more expansive over 2015-2017, with the cyclically-adjusted balance rising from 3.2% in 2014 to 3.6% in 2017. However, the expansion in the structural deficit ratio (the government does not provide information on one-off and temporary measures) against the background of an expected positive output gap in 2016 and 2017 is not explained in the programme.

Box : The budget for year 2015

* On 20 October 2014, the Macedonian parliament adopted the 2015 general government budget, based on an assumption of 4% real GDP growth and 2% inflation.

* The budget foresees an unchanged revenue ratio of 31.6% of projected GDP, and a decline in the expenditure ratio from 35.4% to 34%, compared to the 2014 revised budget.

* The general government deficit target is lowered to 3.3% of GDP, compared to a revised target of 3.7% in 2014.

Main measures in the budget for year 2015

Revenue measures	Expenditure measures
<ul style="list-style-type: none"> • Restriction of tax-exemptability of retained earnings • Reduction of VAT registration threshold (375 mio MKD) • Voluntary delay of retirement age • Social contributions of contractual employees 	<ul style="list-style-type: none"> • 5% increase in social transfers (0.8% of GDP) • Increase in agricultural subsidies

Source: ERP 2015

Public finance management continues to suffer from severe shortcomings. The authorities have taken steps towards improving the management of public finances, such as strengthening budget planning capacities through more accurate growth and revenue forecasting, and they have refined the debt management strategy, which accompanies the medium-term fiscal strategy (but is restricted to general government debt), by laying out specific ceilings for refinancing, currency and interest rate risk. However, overall, work on the design and implementation of a comprehensive medium-term budget and expenditure framework is delayed. The government's budget planning and implementation is currently guided by the medium-term fiscal strategy, which contains binding targets for revenues, expenditures and deficits (yet, these targets may be revised with parliamentary approval in the following year's strategy), but only indicative expenditure ceilings. 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 public expenditure. In view of the numerous public investment projects, prioritisation of productive, growth-friendly capital expenditure needs to be reinforced.

Table II.2.2:
Composition of the budgetary adjustment (% of GDP, general government)

	2013	2014	2015	2016	2017	Change: 2014-17
Revenues	30.2	31.6	31.6	31.0	30.2	-1.4
- Taxes and social security contributions	25.6	26.3	26.2	25.7	25.2	-1.1
- Other (residual)	4.6	5.3	5.4	5.3	5.0	-0.3
Expenditure	34.2	35.4	35.0	34.2	33.2	-2.2
- Primary expenditure	33.3	34.6	33.9	33.0	31.9	-2.7
<i>of which:</i>						
Gross fixed capital formation	4.4	5.1	5.0	5.0	4.8	-0.3
Consumption	11.6	11.9	11.6	10.9	10.3	-1.6
Transfers & subsidies	17.3	17.6	17.3	17.1	16.7	-0.9
Other (residual)	0.0	0.0	0.0	0.0	0.1	0.1
- Interest payments	0.9	0.8	1.1	1.2	1.3	0.5
Budget balance	-4.0	-3.8	-3.5	-3.2	-3.0	0.8
- Cyclically adjusted	-3.3	-3.2	-3.2	-3.4	-3.6	-0.4
Primary balance	-3.1	-3.0	-2.4	-2.0	-1.7	1.3
Gross debt level	34.1	37.7	35.5	37.3	38.7	1.0

Source: Pre-Accession Economic Programme (PEP) 2015. Figures for 2014 are based on the Finance Ministry's projections from mid-2014.

Funding needs of state-owned enterprises are driving public debt levels. General government debt as a share of GDP remains moderate -it stood at 38% of estimated GDP at the end of 2014. However, large-scale infrastructure investments are increasingly financed and administered through state-owned enterprises. Hence, overall public sector debt, which includes guaranteed borrowing by public enterprises, amounted to 46% of GDP. State-guaranteed debt accounted for some 17% of overall public sector debt. As a result, the level of guarantees issued by the government, which constitute contingent liabilities, amounted to 7.7% of GDP in 2014. The programme assumes that the public debt level will not exceed 50% of GDP by 2017, which seems optimistic in view of the significant pipeline of planned public infrastructure investments, in particular Transport Corridor VIII projects financed by the Public Enterprise for State Road (PESR).

Table II.2.3:
Composition of changes in the debt ratio (% of GDP)

	2013	2014	2015	2016	2017
Gross debt ratio [1]	34.1	34.2	34.3	37.3	38.7
Change in the ratio	3.6	0.1	0.1	3.0	1.4
<i>Contributions [2]:</i>					
1. Primary balance	3.1	2.9	2.3	2.0	1.6
2. "Snow-ball" effect	-0.7	-0.9	-0.7	-0.7	-0.9
<i>Of which:</i>					
Interest expenditure	0.9	0.8	1.1	1.2	1.3
Growth effect	-0.6	-1.2	-1.4	-1.4	-1.6
Inflation effect	-0.8	-0.6	-0.3	-0.5	-0.6
3. Stock-flow	0.0	-1.9	-1.5	1.7	0.6

Notes:

[1] End of period.

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

Source: Pre-Accession Economic Programme (PEP) 2015, ECFIN calculations

Incentives to non-guaranteed borrowing by public enterprises decrease transparency of public debt developments. A 2014 amendment to the Public Debt Law restricts possibilities for state-owned enterprises to borrow with state guarantees, while at the same time extending their options of non-guaranteed borrowing. The latter is not included in the public debt definition of the government. In parallel, the government is preparing to limit public debt, at constitutional level, to 60% of GDP. Hence, there is reason for concern that only a decreasing share of further accelerating public enterprise debt would be recorded in the public debt figure.

2.4. STRUCTURAL REFORMS

The authorities broadly identify the main structural reform needs. The programme underlines the need for increased endogenous growth, stimulated by FDI and their links with the domestic economy, higher value-added productions and improved transport infrastructure. Regarding the labour market, the programme identifies, as main challenges, the need to stimulate labour demand, to match the skills of the workforce with labour market needs, and to reduce the informal economy. Quality of higher education and access to capital for private companies are mentioned as further conditioning factors for increasing the competitiveness of the country.

Progress in implementing key reforms is lagging. The programme describes measures aimed at alleviating the major obstacles to growth and employment, in four areas: business environment, financial stability, labour market, and public finance. However, it fails to point out convincingly how the outlined structural reform measures would support the government's macro-fiscal strategy. The presentation of structural reforms in the programme suggests that a number of measures initially envisaged to begin in 2014 were postponed, but it does not state the reasons for the delay. No details are provided in terms of implementation and fiscal impact of the envisaged privatisation of three state-owned companies. The authorities provide a table on the net budgetary impact of key reforms in seven areas/sectors. However, overall, the description of measures is not very detailed, with little information on estimated macro or fiscal impact, nor on methodology or sources.

Developing the domestic private sector remains a key challenge. The government intends to continue its strategy of attracting foreign direct investment in higher-value added sectors, while simultaneously supporting local companies in developing the necessary skills to work as suppliers. To promote linkages, it has undertaken a number of initiatives, through various stakeholder fora involving the local business community and the Chamber of commerce, to identify the main needs of FDI companies, and to match these to local companies. A number of structural obstacles need to be tackled in this regard: the diversification of exports from commodities to chemicals and manufactured products with higher value added progresses slowly; local sourcing by foreign companies remains limited, as a result of lengthy licensing procedures, and also missing skills required by the investor. Companies still face difficult and costly market exit procedures, as bankruptcy proceedings remain cumbersome, in spite of a recent 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. Reform implementation remains, for the most part, in its conceptual stages - in December, the government adopted an Action Plan aimed at further streamlining the requirements for starting a business. A key deficiency in the government's approach to reforming the business environment is the insufficient time given to the business community when consulted on draft legislation, and the increasing number of by-laws not subject to consultation at all. In general, 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 measures need to be better targeted at structural obstacles to employment. Reducing the persistently high youth and structural unemployment rate is a cornerstone of the government's economic policy. Active labour market policies, targeted at improving the employability of

the unemployed, by raising their skills levels and enhancing their chances of long-term private sector employment are at the core of active labour market policy. These measures have generally served to increase participation rates, with the exception of women's participation in the labour market, and to combat unemployment in particular among vulnerable groups of workers. However, there is a need to better tailor these measures to improve participants' skills. This would have to take into account the structural obstacles to labour supply and demand, such as shortcomings in tertiary and vocational education, which may impact negatively on applicants' ability to gain vital skills required on the job market; insufficient involvement of social partners in wage setting; and, reduced options or financial disincentives regarding flexible work organisation. Moreover, while the Employment Service Agency (ESA) conducts regular performance evaluations, there is little information about the criteria used when prioritising among measures. The government is extending the scope and funding of ALMPs in 2015, but information on the content, implementation and cost of measures is missing in the programme. In 2015, authorities intend to further strengthen employment policy by the completion of the Employment and Social Reform Programme, and the preparation of a new Employment Strategy. Yet, information on the implementation of the previous Employment Strategy is missing, so that a proper assessment is difficult. Authorities also fail to inform on the implementation of the 2013 strategy to reduce the informal economy, and on their work on a law incentivising so far undeclared bigger businesses to register lawfully.

Major areas of public finance are in need of reforms. The government enacted a number of revenue- and expenditure measures, such as voluntary extension of retirement age, a new requirement for contractual workers to pay social insurance contributions, a reduction of the VAT registration threshold, and a more restrictive tax exemption of reinvested profits. However, while these measures might somewhat bolster public revenue, major structural reforms of important areas of public finance need to be undertaken, in particular the strengthening of budget planning capacities; the implementation of a medium-term expenditure framework; and, clear procedures for prioritising public investment spending.

2.5. IMPLEMENTATION OF THE 2014 POLICY GUIDANCE

In line with the targeted policy guidance set out in the conclusions of the Joint Ministerial Dialogue in May 2014, the authorities have taken some modest steps towards implementing some of the recommended reforms. Implementation of the "regulatory guillotine" measures for improving the business environment progressed. Bank lending to the private sector picked up, aided by targeted monetary policy measures. Financial stability benefited from increased denomination of assets and liabilities in domestic currency. The government enhanced the transparency of overall indebtedness of the public sector by resuming the publication of the debt of state-owned enterprises. Yet, overall, progress has been limited, in particular regarding recommended steps to improve budget planning capacities, fiscal discipline and the composition of spending, as well as regarding the need to establish linkages between foreign companies and the local economy.

Box : Implementation of the 2014 Policy Guidance

1. Implement the 2014-2016 medium-term fiscal strategy as planned and protect the execution of growth-enhancing capital spending by preparing contingency fiscal measures to compensate for unexpected revenue shortfalls or expenditure pressures; adopt a cautious and selective approach to the issuance of sovereign guarantees.

- While the government proposed fiscal rules at constitutional level, it relaxed the fiscal consolidation path in the 2014 medium-term fiscal strategy.
- In 2014, growth-enhancing capital spending fell again victim to a mid-year budget revision, in light

of revenue under-performance and of a sizeable rise in statutory transfer payments (pensions, social transfers, agricultural subsidies).

- The level of state guarantees increased further in 2014 by 0.8pp, to 7.7% of GDP. The new Public Debt Law foresees more restrictive conditions for public sector companies to obtain state guarantees for their borrowing. It incentivises non-guaranteed borrowing, which is not included in the government's definition of public debt.
 - The programme does not contain information on contingency measures in the 2015 budget to compensate for unexpected revenue shortfalls or spending pressures.
2. *Improve the composition of spending, by prioritising investment projects according to their productive potential, and by better targeting social expenditure; perform regular cost-benefit evaluations of social spending and of investment projects.*
- The composition of general government spending did not improve in 2014. Implemented capital expenditure amounted to 10.5% of total expenditure, or 3.4% of GDP, slightly below pre-year level. This does, however, not take into account investment financed by state-owned enterprises. Compared to the revised budget, implementation amounts to only about 83%, no better than in 2013. Meanwhile, transfers from the central government budget to the pension fund accounted for about one quarter of total expenditure. Together with transfers to the health fund and agricultural subsidies, they made up the overwhelming bulk of government expenditure.
 - The government made improvements in the IT interconnection of different parts of the social security system in order to target social transfers towards the most vulnerable groups. However, no information on the fiscal impact is provided.
 - The programme does not contain information to what extent the prioritisation of investment projects was based on cost-benefit evaluations.
3. *Improve medium-term budget planning and execution; regularly update the public investment plan, increase fiscal transparency by providing more detailed data on planned and executed capital expenditure, including that of public enterprises, in the context of the annual budget cycle and the medium-term strategy, as well as by adhering to EU accounting standards, notably ESA 2010, and by resuming the submission of fiscal notifications.*
- The government made some efforts towards improving fiscal transparency. It resumed the publication of public debt data, which includes the guaranteed part of public enterprise debt. However, transparency was impacted negatively by the suspension of the ex post yearly budget execution report (even though the information is still available informally on the Ministry's website); the continued off-budget shift of major capital expenditure to state-owned enterprises; the likely building-up of arrears in different parts of the public sector; and, opaque budget classification of expenditure items.
 - The government has not submitted a fiscal notification to Eurostat in recent years, although it anticipated doing so in 2014. On the other hand, the transition of national accounts data to ESA 95/2010 is ongoing, with GDP data for 2000-2012 revised in 2014.
 - Budget planning capacities benefited from an EU-assisted project on improving macroeconomic and public revenue forecasting. Work on setting up a medium-term expenditure framework is protracted, and an EU-assisted project is now due to begin in autumn 2015. Technical work towards programme classification of expenditures, based on international common practice, is

ongoing in the Ministry, but implementation is not imminent.

4. *Improve the employability of workers, by better aligning vocational and tertiary education with labour demand needs, better target active labour market policies and publish regular performance evaluations.*
 - The government increased the extent and the funding for active labour market measures. Without providing detailed information, the authorities mention in the programme that a number of employment programs have been evaluated by the Employment Agency in 2014, and taken into account in the design of measures for 2015.
 - Structural reforms in the education sector aimed at enhancing skills and improve employability, such as the implementation of the vocational education and training reform, are protracted.
5. *Accelerate the further implementation of the "regulatory guillotine", including the facilitation of licensing procedures for new companies through the quick completion of the one-stop shop system for business registration; and establish a fast and inexpensive bankruptcy procedure; implement the innovation strategy, including the efficient functioning of the Innovation Fund.*
 - Implementation of the remaining measures of the regulatory guillotine project's phases II, III and IV is ongoing, and the one stop shop company registration system is now fully operational and carried out electronically. The duration and recovery rate of bankruptcy procedures improved somewhat, in response to pre-2014 changes to the legal framework. There is little information in the programme on the extent of implementation of the 2013-2015 Innovation Strategy Action Plan.
6. *Continue to take measures to repair the bank lending channel, including by fostering the clean-up of non-performing loan portfolios and make further progress to reduce indirect financial stability risks by promoting the use of the domestic currency.*
 - Supported by accommodative monetary policy well into 2014, credit growth to the private sector picked up markedly in 2014, at last also reaching the corporate sector. The rate of NPLs remains elevated, yet still fully covered by banks' provisions. The use of domestic currency on both, the asset and liabilities sides, progressed further, aided by targeted monetary policy measures.

2.6. THE 2015 POLICY GUIDANCE

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning part I of the ERP, Participants hereby invite the former Yugoslav Republic of Macedonia to:

1. Improve the management of public finances by adhering rigorously to the 2015-2017 medium-term fiscal targets outlines in the ERP, and frontload consolidation so as to be on track for the 2017 budget deficit target of 2.9% of GDP. Use any additional fiscal space for further consolidation measures, so as to protect growth-enhancing capital spending in case of unexpected budget pressures. Keep tight control on the development of transfer payments, pensions, and public wages. Introduce a medium-

term expenditure framework. Inform in a timely and regular manner on the size of the government workforce and payroll.

2. Improve the composition of spending, by prioritising investment projects according to their productive potential, and be more transparent on the cost-benefit analysis underlying transfer and investment spending items on the budget. Provide more timely and detailed data on planned and executed capital expenditure.
3. Improve the fiscal transparency by including more comprehensive data on the debt of public companies and contingent liabilities in the government's debt management strategy and inform about arrears. Speed up transition to ESA 2010 reporting and resume fiscal notifications. Continue to keep tight control on guaranteed and non-guaranteed borrowing by state-owned enterprises and municipalities.
4. Improve the employability of workers, by better aligning skills with labour demand needs notably by developing the education system. Strengthen performance evaluations of active labour market policies with a view to better targeting skills development, and inform on their methodology and results in a timely manner.
5. Step up efforts to create supply linkages between foreign and domestic companies with a view to enhancing productivity and employment in the domestic economy.
6. Increase efforts towards facilitating the disposal of non-performing loans by banks, involving all key stakeholders including the central bank as necessary, with a view to removing potential obstacles to credit extension in the context of a sustained pick-up in credit demand.

Concerning Part II of the ERP, Participants invite the former Yugoslav Republic of Macedonia to:

7. Review the transport strategy in order to align it with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network) and establish a credible planning and funding mechanism. A single sector pipeline would help prioritise investments.
8. Improve the business environment by implementing the Master plan for Competitiveness and the related Government Action Plan. These should include measures affecting competitiveness, such as a more predictable legal and regulatory environment, enforcement of contracts, respect of IPRs, payment discipline, labour legislation, quality and integrity of inspection services, etc. Ensure regular and structured dialogue with social partners regarding the implementation and review of the Master plan. Step up efforts to fight against corruption and informalities in the economy.
9. Improve access to finance for SMEs and speed up bankruptcy procedures. Continue with the implementation of the innovation strategy, and step up the use of instruments foreseen by the Innovation Fund.

Annex: Overall assessment of programme requirements

The Economic Reform Programme was adopted by the government on 29 January 2015, and submitted on 30 January 2015. It was drafted in consultation with the social partners. It covers the period 2015-2017 and is broadly in line with the government's medium-term fiscal strategy and the 2015 Budget Law. Responding to the requirements to progressively adapt the economic and fiscal surveillance of the enlargement countries 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 an accurate review of recent macroeconomic developments largely based on the most recent available data at the time of drafting. It contains a plausible, although slightly optimistic medium-term macroeconomic framework, taking into account the expected impact of the main structural reform measures underway, and pointing out the main risks to the scenario. The authorities present an alternative scenario based on lower growth in the country's trade partner economies. The presentation includes an analysis of the external position, including the development and breakdown of gross external debt and of the international investment position. While focussed on trade developments, the presentation contains an enhanced analysis of external debt sustainability, compared to last year's programme, including details on external financing needs and repayment capacity, as well as standard indicators of external indebtedness.

Fiscal framework

The programme provides fiscal projections for 2015 to 2017, in line with the presented medium-term macroeconomic scenario. Data reliability is, however, limited by insufficient comparability with ESA 95 classification. Also, the data provided in the programme is in some instances not in line with the respective figures provided in other key documents, such as the medium-term fiscal strategy or the 2015 Budget Law. In some parts, it refers to the original 2014 budgetary estimates, not taking into account the budget revision in autumn 2014, which led to adjustment of the deficit target for 2014. The authorities failed again to submit a fiscal notification in 2014, rendering it difficult to compare published data with benchmarks according to EU accounting standards. There is limited 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 an overview of ongoing and planned policy measures in the key reform areas, which they link to the identified major obstacles to growth. The presentation remains rather general and would have benefitted from more information on intended targets, expected results, financing sources, and implementation schedules. Moreover, it is not clear how the programmes that are presented relate to the categories used in the government budget. The customary table on the net budgetary impact of individual reform measures by policy area has been shifted to the second part of the programme.

Implementation of the 2014 targeted policy guidance

The programme contains information on action the authorities have undertaken in response to the Council's 2014 policy guidance. The presentation remains general, in large part, and would have benefitted from more concrete description of individual measures. Also, a number of measures mentioned remain at the planning stage, without clear information on intended implementation. Some measures refer to initiatives taken before the 2014 targeted policy guidance was issued.

3. MONTENEGRO

3.1. EXECUTIVE SUMMARY

The macroeconomic scenario presents a mild recovery in 2014, reflecting falling industrial production and exports. Domestic demand remains subdued, constrained by scarce and expensive bank lending and retrenchment of government consumption. External imbalances remain structurally substantial, symptomatic of a narrow production base and the weak competitiveness of local producers. Although recording some improvement, the unemployment rate is still very high, in particular for the young and long-term unemployed. After several years of cutting capital investment, the government will launch in 2015 the construction of a highway which, together with a series of large private investments already under preparation, will set the context for the mid-term macroeconomic and fiscal scenarios. The programme also presents a low-growth scenario, defining a delay of private investments, decline of tourism, and the increase of risk aversion on capital markets as major threats to economic growth.

The fiscal framework has been articulated around these macroeconomic challenges, and becomes more elaborated, implementing a comprehensive growth-enhancing tax policy reform. The fiscal strategy is frontloaded, with many of the measures of the tax reform already adopted in early 2015, but also it remains flexible, open to additional measures in case of need. The principal objective of the fiscal strategy is to reinforce the sustainability of public finances, and for this, a series of new tax rises are introduced. Part of the extra revenue generated by these measures should allow a shift of the tax burden in favour of investment. These will include a rebalancing of the tax wedge as well as fiscal incentives to attract new investments to strategic sectors (tourism, energy and food), and thus broaden the production base, increase competitiveness and reduce external imbalances. Another part of the extra revenue generated by the tax reform is intended for financing capital investments, and in particular, the highway; which represents the major risk for the fiscal scenario due to the possibility of cost overruns.

The structural reform agenda complements and reinforces the fiscal strategy, targeting the same macroeconomic challenges. Therefore, to stimulate diversification and competitiveness of the economy, the ERP presents a series of measures to improve the business environment in order to attract investments. To solve the problem of tight and expensive credit conditions to the real sector, authorities present a plan for debt restructuring (called 'Podgorica approach'), reinforced by fiscal incentives as well as by amending the legal framework to facilitate contract enforcement and debt recovery. Another group of reforms aim to reinforce human capital (in particular education and skills) in addition to current active labour policy measures. To reinforce long-term fiscal stability, the programme proposes the rationalisation of public sector wages as well as a (rather vague) review of the pension system.

A new and important part of this year's programme is the stocktaking on the targeted policy guidelines set out in the conclusions adopted by the Joint Ministerial dialogue of 6 May 2014. The results are mixed and some policies are left undefined. Only a few recommendations have been implemented or are close to being so. Others are still at a very preliminary phase or have only been partially implemented, while, in a couple of cases, last year's measures are discarded in favour of considering deeper reforms.

3.2. ECONOMIC OUTLOOK AND RISKS

A new investment cycle sets the context for the programme's macroeconomic and fiscal scenarios. After several years of cuts into capital investment, the government will launch in 2015 the construction of

a highway⁽¹⁾. This project, together with other large investments in energy and tourism, will become the main drivers of growth in the coming years. A precise assessment of the impact of these works remains difficult, especially when considering the small size of the economy and the substantial import component of investments. The ERP baseline scenario presents a growth path slightly higher than the Commission's winter forecast for 2014 and 2015, although it is more similar for 2016. The programme estimate for 2014 appears optimistic considering the economy expanded by mere 1.1% in the first three quarters of the year and preliminary data for the last quarter points to weak domestic demand and a further deterioration of net exports. The ERP also appears more optimistic concerning the contribution from net exports in 2015 and 2016, with both exports and imports of goods and services expanding by 5% each year, while the Commission foresees a lower export performance, in particular for 2015 considering the unfinished restructuring of the metal industry and tourism capacity constraints.

The programme appears more conservative regarding domestic demand projections, in particular for investments, although it also presents a lower import-dependence elasticity index. Private consumption is broadly similar to the Commission projections, although in the ERP scenario disposable income appears to be fuelled by faster credit growth rather than improved labour performance. The programme also appears confident on maintaining current public consumption levels, in particular for 2016, which is consistent with the restrictive fiscal policy implemented by the government in the last few years, in particular for public sector wages and pensions, although the authorities are coming under increased pressure by trade unions and pensioners. On the supply side, the programme understandably expects strong growth in construction, and to a lesser extent, mining and quarrying (for construction materials), electricity and agriculture. Yet, the services sector remains the key driver of Montenegrin growth.

Table II.3.1:

Comparison of macroeconomic developments and forecasts

	2013		2014		2015		2016		2017	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	3.3	3.3	1.4	2.0	3.0	3.5	3.7	3.8		4.0
<i>Contributions:</i>										
- Final domestic demand	2.9	2.9	2.9	1.1	4.7	3.1	5.8	4.8		5.4
- Change in inventories	-1.1	-1.2	-0.3	0.3	0.0	1.2	0.5	0.0		0.1
- External balance of goods and services	1.6	1.6	-1.2	0.6	-1.7	-0.8	-2.6	-1.0		-1.5
Employment (% change)	0.1	3.0	1.4	0.8	1.8	1.5	2.0	1.2		0.8
Unemployment rate (%)	19.4	19.5	19.2	19.4	18.4	18.2	16.8	17.6		17.2
GDP deflator (% change)	2.3	2.2	-2.8	0.0	-0.6	1.0	1.0	1.5		2.0
CPI inflation (%)	1.3	2.2	-0.7	-0.5	0.4	1.0	2.0	1.5		2.0
Current account balance (% of GDP)	-14.6	-14.6	-15.3	-14.2	-15.6	-13.3	-16.9	-13.8		-14.6
General government balance (% of GDP)	-5.3	-4.8	-3.0	-1.5	-5.7	-5.3	-4.8	-5.0		-4.0
Government gross debt (% of GDP)	58.1	58.0	58.2	57.7	62.3	63.2	65.6	67.0		69.1

Sources: Economic Reform Programme (ERP) 2015, Commission Winter 2015 forecast (COM)

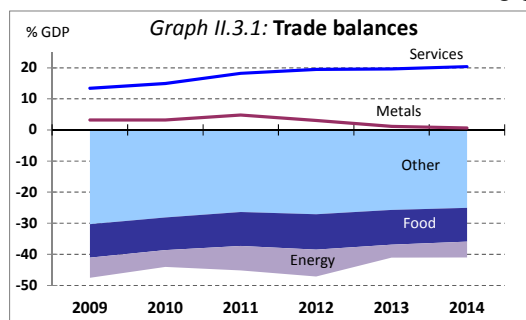
Downside risks predominate in the short and medium-term. As in previous years, the economic programme presents an alternative "low-growth" scenario. Yet, the main assumption is that the construction of the highway will be maintained even in case of major economic downturns. Given the sheer size of this investment –for which 85% of the funds are already secured–, GDP growth is only slightly reviewed downwards (between 1.4 and 0.8 percentage points lower). The programme identifies three key risks or shocks for this scenario: a deterioration of global financial market conditions leading to rising financing cost for domestic agents, geopolitical tensions, and decline of oil prices resulting in a

⁽¹⁾ Mentions to the highway in this report refer to some forty kilometres (depending on the final variant) of the Smokovac-Mateševo section of the Bar-Boljare highway. The total value of this section is planned at EUR 809 million, or around 5% of GDP annually during the for year construction period. The exact profile of disbursement will remain unclear until construction works start.

decline in the number of Ukrainian and Russian tourists visiting Montenegro accompanied by further delay in tourism and energy investments. The exchange rate risk is also mentioned in the document but not explicitly in this scenario. Considering the relatively small revision of the low-growth scenario, unless otherwise indicated, the assessment of the programme refers to the baseline scenario.

International commodities prices exert downward pressure on headline inflation. These may be further exacerbated by exchange rate fluctuations, in particular of the US dollar and the Serbian dinar vis-à-vis the euro for oil and food imports, respectively. In 2014, global trends in telecommunications as well as the decline of domestic wages had a disinflationary –although much lower– effect on the prices for some services too, like communications, recreation and culture, education and domestic services. The inflation econometric model of the Ministry of Finance (based on historical data, EU projections, and other exogenous variables) offers a medium-term scenario with a gradual increase of prices stabilising at around 2% in 2017. The Commission model forecasts a steeper increase in prices on the assumption of a faster growth of earnings and private consumption, resulting from slightly higher employment projections. Discarding a deflationary situation, the main issue of a low inflation scenario would be a nominal expansion of the public debt to GDP ratio (i.e. denominator effect).

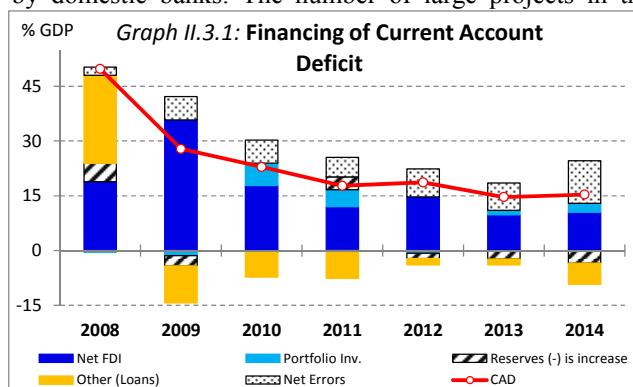
The structural character of the current account deficit reflects the narrow production base and prevalence of services. Thus, the current account deficit broadened to 15.3% of GDP in 2014 up from 14.6% a year before, driven by the deterioration of the trade deficit to 40% of GDP. The merchandise imbalance reflects the weak performance of exports, notwithstanding strong base-effects from utilities production a year earlier and the ongoing restructuring of the metal industries, compared to substantial and slightly growing import flows (51% of GDP). Despite a poor start of the tourism season, the number of visitors recovered in the last months of the year, supporting a marginal expansion of the services balance surplus to 20% of GDP. Yet, the contraction of the current transfers and factor income balances surpluses -summing up additional 4.8% of GDP– proved insufficient to reduce the overall external gap. To address these large imbalances, the ERP announces further policy action to increase investments and engaging domestic potential in sectors enjoying comparative advantage, like energy and tourism, with positive spillovers on construction, transport, retail trade and mining (for coal and for construction materials), but also agriculture and food, which despite their limited potential, may alleviate external imbalances through some import substitution.



The programme presents an analysis of the competitiveness of the Montenegrin economy, comparing the real effective exchange rate (REER) of 26 trade partners (including for tourism). The CPI-based model reflects the sharp depreciation of the Russian, Ukrainian and Serbian currencies vis-à-vis the euro since mid-2013, totalling an 8% decline of Montenegro's export competitiveness since 2010 for these markets. The study also reveals that food import prices (mostly Serbian) did not decline as much, due to the fact that terms of trade are settled in euros. The ULC-based model reflects a continuous albeit slight gain in labour competitiveness following wage moderation in Montenegro since 2012 and continuing well into 2018, as GDP grows faster than employment and wages, increasing domestic productivity. Lastly, the ERP analyses the obstacles and measures to enhance the competitiveness of the important⁽¹⁾ tourism sector.

(¹) Montenegro's tourism industry accounts for some 20% of GDP, including direct and indirect effects.

The current account deficit is largely financed by net FDI flows topped by other transfers recorded under net errors and omissions. The large inflows of loans fuelling massive external deficits in the past, reversed with the outbreak of the global financial crisis in 2008 and have remained in negative territory since then, signalling the continuation of deleveraging by domestic banks. The number of large projects in the pipeline to be financed through FDI foretells –given the import dependency of the economy– a resurgence of external imbalances in the coming years. The ERP does not offer an analysis of the net international investment position (NIIP) given the central bank's difficulties in calculating the external debt in the context of an euroised economy. The IMF estimates Montenegro's external debt to have increased to some 133% of GDP in 2014, driven in part by public debt which



accounts for some 45% of the total. The debt trajectory is vulnerable to various shocks, in particular to a depreciation of the euro. Although this would only affect a small part of the trade exchange, most of it being settled in euros, the financing of the highway is a particular case as the loan for this project was extended in US dollars. Authorities are considering a swap arrangement to hedge the loan's exchange rate risk.

The banking sector remains stable, liquid and relatively well capitalised, but financial conditions remain tight. In 2014, bank's capital grew by 11.5% y-o-y, raising the aggregate solvency ratio to 16.2%, well above the prescribed minimum of 10%. Banks' assets expanded by 5.9% y-o-y to 92.4% of GDP, and deposits by 10% y-o-y to around 68% of GDP. However, credit activity remains limited and expensive, due to the still high share of non-performing loans, making 16.8% of total loans at the end of 2014, compared to 18.4% a year earlier. As a result, credit growth remained in negative territory, contracting in 2014 by 1.9% y-o-y. The average effective lending interest rate on new loans also declined, although slightly (by 0.4pps y-o-y) to 9.02%. The programme relies on the Law on Voluntary Financial Restructuring of Debts to Financial Institutions (so-called 'Podgorica Approach'), to reduce the stock of impaired loans and thus contribute to the revival of lending to the real economy. However, this could prove insufficient if unaccompanied by additional measures to reduce the risk premia, such as more efficient enforcement of contracts and collateral (also included in the ERP). The central bank also considers other measures, like setting temporary administrative caps on lending interest rates in case these do not decrease in the coming months.

3.3. PUBLIC FINANCE

The 2014 budget execution presents a significant improvement compared with previous year. The deficit declined to preliminary 1.47% of GDP compared to revised 4.8% of GDP a year before, albeit still marginally above the 1.3% target. The 2014 budget presents a primary surplus of 0.8% of GDP; the first one since the outbreak of the crisis in 2008. Yet, improvement appears concentrated on the revenue side. General government total revenue rose to 46.2% of GDP, or EUR 124 million more than a year earlier and planned. Particularly strong performance was recorded from VAT, social security contributions, fees and personal income tax revenue. On the expenditure side, total spending reached 47.7% of GDP, or EUR 28 million more than a year before, and EUR 152 million more than planned too. The significant deviation from the target results from additional capital spending following the increase of state equity in the electric power company after a debt-equity swap arrangement of EUR 54 million, but also, EUR 18 million of state guarantees pertaining to a bankrupt state-owned newspaper and some other small

companies. Budget spending may appear overstated⁽¹⁾ after including EUR 65 million (or 1.9% of GDP) from net increase in liabilities related to previous years. As a result of the above –and pending future revisions– the central government preliminary deficit totalled 3% of GDP (double than planned). By contrast, local governments' budgets (notwithstanding substantial payment arrears), presented an aggregated surplus of 1.7% of GDP which helped to improve the overall balance.

The reduction of public debt becomes the overarching goal of the fiscal strategy. Last year's programme (PEP) presented fiscal stability as the main objective; to be achieved essentially by the continuation of consolidation measures in view of rebuilding fiscal buffers and reducing public debt. Confronted with a surge in public debt and deficit to finance investments, this year's fiscal strategy becomes more elaborated, and adopts a three-pronged growth-enhancing tax policy reform⁽²⁾ to: a) ensure the sustainability of public finances, b) change the tax burden in favour of investment, and c) improve the business environment. These investment friendly measures are intended to boost economic growth and thus generate additional spillovers from tax revenue while reducing public debt nominal parameters.

The 2015 budget denotes a fiscal expansion driven by lowering taxes and boosting capital investment. The structure of spending is conducive to growth by supporting capital spending and investments. The general government budget projects a deficit of 5.3% of GDP relying on real output growth of 3.5% and mild average inflation of 1%. Total budget revenues are planned at 42.9% of GDP, or one percentage point lower than a year before. Total spending represents 48.2% of GDP; of which 34.1% of GDP for current spending (or one percentage point lower than a year earlier), and a twofold increase in capital spending to 9.2% of GDP. When excluding highway spending, the budget would offer a 0.5% surplus.

Box: The budget for year 2015

* On 28 December 2014, the Parliament adopted the Budget Law for 2015, targeting a deficit of 6.6% of GDP for the **central government**. Current budget revenues are planned at EUR 1,329 million (or 37.5% of GDP), current expenditures at EUR 1,280 million (36.1% of GDP), and capital investment at EUR 284 million (8% of GDP) of which, EUR 206 million (or 5.8% of GDP) are planned for the highway works.

* **Local governments** (23 of them) adopt their own budgets. Their aggregate weight makes some 4% of GDP which, compared to the general government budget of 48% of GDP, is rather limited. However, these municipalities habitually present –and the ERP projects– a combined annual cash surplus of around 1% of GDP (due to spending arrears), which helps to statistically reduce the preliminary **consolidated general government** budget deficits.

Table: Main measures in the budget for year 2015

Revenue measures*	Expenditure measures**
a) to ensure the sustainability of public finances:	c) to improve the business environment:
- Increase of excise duties on gasoline, alcohol, tobacco and carbonated drinks (EUR 7 million/year)	- Introduction of tax exemptions for VAT, customs, utilities, fees and charges for investment in strategic sectors (tourism, energy and food). (tax neutral; concerns simplification of procedures and improvement of liquidity)
- Increase of tax on use of tobacco products and electro acoustic devices paid by restaurants (EUR 1 million/year)	- Phasing-out of utilities charges; and - Elimination

(1) According to the European System of Accounts (ESA2010) this financial transaction from previous years could be reclassified 'below the line' and the overall deficit consequently reviewed.

(2) See 'Analysis of specific tax policy aspects', GOM, December 2014.

- New charge on fuel price of 5 eurocents per litre. (EUR 9 million/year)	of double taxation on road use (municipalities) (EUR 21 mn/ balanced with revenue measures)
- New tax on coffee; and - Inclusion of revenue from gambling as personal income (with 15% tax rate) (EUR 3.2 million/year)	
- Introduction of criminal charges for payment of wages without social contributions and taxes (suppressing the grey economy) (EUR 5 million/year)	
- Introduction of collateral for tax liabilities of companies solvent but illiquid (fiscally neutral relief measure)	
- Increase of the real estate basic rate from minimum 0.1% to 0.25% of market value (municipalities) (EUR 21 mn / balanced with expenditure measures)	
b) to change the tax burden in favour of investment:	
- Increase of health insurance social contribution paid by employers by 0.5 percentage points (EUR 5.6 million/year [net, EUR 4.1 million])	- Reduction of the Personal Income Tax (PIT) upper bracket rate from 15% to 13% (EUR 4.8 million/year)
Other measures	
	- Unfreeze of pension indexation ⁽¹⁾ (EUR 2 million)
* Estimated impact on general government revenues.	
** Estimated impact on general government expenditure.	
Sources: ERP 2015, 'Analysis of specific tax policy aspects', GOM, December 2014	

The government has adopted an extensive tax reform comprising a set of fiscal laws introducing a series of measures (see box above) to alleviate the financial burden from the new road construction on Montenegro's small economy. The net impact of these revenue measures has not been incorporated in the ERP baseline projections; although it is estimated at around EUR 17 million in 2015 (due to the lag on implementation), and EUR 25 million per year thereafter, which together with a (very hypothetically) similar amount from the toll fee once the road is completed, and factoring in the indirect impact on economic growth, this could suffice to repay the loan⁽²⁾ in case of no major cost overruns.

The programme presents a very preliminary projection of capital expenditures, dividing the total cost of the road into four equal annual instalments, thus probably overestimating the deficit for 2015. The

⁽¹⁾ The pension indexation system was amended to avoid pension cuts in case of negative rates of prices and wages. This would have been the case in 2015 based on 2014 indices.

⁽²⁾ The contract stipulates that the road should be built in 4 years. The grace period to start reimbursing the loan's principal is six years; annual instalments would be EUR 45 to 50 million. After construction, the government may consider the possibility of offering the road on concession.

Commission's winter forecast assumes that only part of the ERP estimate could be disbursed in 2015, as works are supposed to start –in case there are no further delays– in May, and pick up progressively in the following years. The deficit and debt scenarios will likely need to be revised once further details on the road's technical planning are available.

Table II.3.2:
Composition of the budgetary adjustment (% of GDP)

	2013	2014	2015	2016	2017	Change: 2014-17
Revenues	43.4	46.2	42.9	41.4	40.3	-5.9
- Taxes and social security contributions	37.9	41.1	38.4	37.1	36.1	-5.0
- Other (residual)	5.4	5.1	4.5	4.3	4.2	-0.9
Expenditure	47.7	47.7	48.2	46.4	44.3	-3.4
- Primary expenditure	45.6	45.3	45.9	44.2	42.2	-3.1
<i>of which:</i>						
Gross fixed capital formation	3.7	3.8	9.2	8.9	8.6	4.8
Consumption	17.7	19.9	17.0	16.2	15.3	-4.5
Transfers & subsidies	18.8	18.8	19.5	18.8	18.0	-0.8
Other (residual)	5.4	2.9	0.4	0.3	0.3	-2.5
- Interest payments	2.1	2.3	2.3	2.2	2.0	-0.3
Budget balance	-4.8	-1.5	-5.3	-5.0	-4.0	-2.5
- Cyclically adjusted	-2.0	-2.4	-6.3	-5.4	-4.4	-2.0
Primary balance	-2.7	0.8	-3.1	-2.8	-1.9	-2.8
Gross debt level	58.1	59.6	63.2	67.0	69.1	9.5

Sources: Economic Reform Programme (ERP) 2015, MoF update.

The basic features of the 2015 budget are extended to the outer years too. The programme –apart from the detailed budget tables in the annex– does not announce any other particular measure for 2016 and 2017, as these are mostly frontloaded in 2015. Revenue projections are moderately cautious, calculating an increase in tax revenue of one percentage point less than the expected real expansion of the economy. This translates into a nominal growth in taxes returns for 2016 and 2017 of 1.4% and 3.2% y-o-y respectively, except for personal income tax revenue, which is planned at the same level as in 2015 on the assumption that the reduction of the upper tax bracket would be offset by employment gains.

Consolidation efforts appear ambitious on the expenditure side, anticipating a modest increase in current spending of 1% y-o-y in nominal terms for 2016 and 2017 (i.e. below the estimated inflation growth rate), although faster for capital expenditure, expanding slightly above tax revenue projections rates (2.7% and 3.4% y-o-y respectively). While revenue planning appears plausible (after over-performing in the last two years), the rather modest increase of current spending, in particular public wages and pensions, may underestimate a revival of social pressure for raising them after several years of containment. Experience also shows that capital spending is prone to cost overrun, which although identified in the sensibility analysis risk (with a 10% over-cost risk), it is not, however, reflected in the low-growth scenario figures (see below). A series of structural reforms should also help to improve the budget's sustainability in the long term. These concern some changes –not detailed– to the pension system, the alignment of public sector wages across administrations, the reform of the health system, and better targeted welfare aid.

The programme low-growth fiscal scenario is based on the occurrence of geopolitical risks in Eastern Europe resulting in negative spillovers on foreign investments, tourism, and financing costs leading to lower economic growth. However, the scenario fails to reflect these negative impacts on the revenue side of the budget, justifying –on the contrary– upside risks for budget revenue from the multiplicative effects of the highway construction. This alternative scenario foresees an increase in current expenditure and the budget deficit of just one percentage point of GDP, resulting from transfers

for unemployment and subsidies. The ERP also reflects on the risk of possible cost overruns of the highway, and announces in such case a preference for additional fiscal measures instead of halting the project. The stakes are high and authorities seem conscious of the risks, exposing a number of reasons – other than merely fiscal, like improving transport security and costs, regional integration, trade and tourism– to pursue the road project.

The introduction of fiscal rules with the 2015 budget will stress-test the quality of public finances and budgetary planning. In April 2014, the parliament adopted the Law on Budget and Fiscal Responsibility (i.e. fiscal rules), which prescribe upper limits for the budget deficit and public debt of 3% and 60% of GDP respectively. According to this law, should the deficit or debt exceeds the thresholds due to implementation of capital projects for which the borrowing has been decided by the Parliament (as in the case of the Bar-Boljare Highway Law), the government must propose a reduction programme for a period⁽¹⁾ not exceeding five years. The 2015 budget, in which the fiscal rules apply for the first time, already presents an excessive deficit of 5.3% of GDP. Consequently, the mid-term framework accompanying the budget –on which the ERP is based– presents the government's reduction programme with a gradual correction of the deficit to reach 2.8% of GDP by the end of 2018. Overall, the assessment of the budget performance against this reduction programme will offer a clear benchmark of the capacity and commitment of Montenegro to reduce fiscal imbalances.

In the context of EU accession negotiations, the Ministry of Finance is currently designing the alignment of Government Finance Statistics (GFS) cash-base reporting with the accrual-base European System of Accounts (ESA2010). In October 2014, Montenegro transmitted for the first time Excessive Deficit Procedure (i.e. Fiscal Notification) tables to Eurostat on a best-effort basis. Until 2013, sizeable discrepancies could appear every year when the parliament cleared the previous executed budget (Law on Budget Final Account), as the preliminary deficit added up net increases in liabilities relating to unforeseen state arrears and (unfavourable) judicial cases resolutions. To avoid discrepancies when clearing the executed budget in parliament, the central government deficit for 2014 was already reviewed downwards to -3% of GDP from preliminary -0.7% cash-basis, taking into account anticipated repayment of arrears and net increase in liabilities from previous years. This may result in an overestimate of the 2014 budget execution as, according to ESA2010 rules, this arbitrary accounting adjustment might be reclassified below the line.

(¹) Note: the fiscal rules do not include a timeframe by which the deficit or debt ratios have to be reduced below mandated levels.

Box: Debt dynamics

In 2014, the public debt reached 59.6% of GDP, up from 58% a year earlier. A large proportion of public debt (almost 80%) relates to external creditors, while domestic debt accounts for 18%, and state-owned companies additional 2%. The aggregated public debt average interest rate was some 4.6%. Around 90% of the debt is denominated in euros, the rest mostly relates to Special Drawing Rights (SDR), US dollars and Swiss Francs.

Capital markets financing conditions are gradually improving. In March 2015, Montenegro successfully placed a EUR 500 million 5-year bond at a rate of 3.87% to refinance around EUR 400 million of state debt placed in two 5-year Eurobonds issued in 2010 and 2011 at an aggregate rate of 7.85%. Some EUR 30 million of the new debt emission is intended to finance the budget deficit in 2015 and additional EUR 36 million for settling obligations of the Health Fund.

The financing of the highway represents the main risk for public finances. The ERP baseline scenario offers an extended timeline for the gross debt ratio until 2019 (see table). Although very basic, it has the merit to broadly illustrate the debt path (surging in 2015 and dropping in 2019). The total cost of the road section is estimated at 23% of 2015 GDP estimate, of which 85% is already secured by a loan from the Chinese Exim bank with very favourable financing conditions. The government would withdraw some EUR 172 million or 4.8% of GDP from the credit line in 2015. There are also exchange rate risks as the loan was extended in US dollars, and the exchange rate contractually fixed. So far, with the depreciation of the euro against the dollar, it will increase the purchasing power of the borrower, but this situation could reverse in the future, at the time of reimbursement. To remediate this risk, the Ministry of Finance is considering the possibility of hedging the loan. Another important risk of this road project is cost overruns, covered to some extent by a performance bond issued by the Chinese construction companies. These risks will require a strict management of the project and the preparation of contingent fiscal plans in case of slippage, but also, in case of faltering economic growth and/or low inflation, two important factors to help reducing public debt in nominal terms. For instance, in the alternative low-growth scenario, in case of moderation of the GDP growth effect the public debt could attain 74% of GDP in 2018 (compared to 69.9% in the baseline).

The risk of activation of state guarantees have been significantly reduced after the bankruptcy episodes of the metal industries. At present, state guarantees bear a more limited risk as they are for the most part extended in favour of international financial institutions and agencies to finance public infrastructure projects, instead of distressed public companies.

The issue of tax arrears appears concentrated at local government level. The combined outstanding debt of the Montenegrin municipalities to the state authorities, banks and suppliers totalled EUR 350 million (or 10% of GDP) at the end of 2014, compared to EUR 187 million a year earlier. Out of the total amount, 48% relate to bank loans (i.e. public debt), while additional 32% refer to liabilities towards the state and suppliers. In February 2015, the government approved a 20 years plan for reprogramming EUR 89 million of tax arrears of 14 municipalities. One of the conditions of this plan requires the consent from Ministry of Finance before hiring any new employee.

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

	2014	2015	2016	2017	2018	2019
Gross debt ratio [1]	59.6	63.2	67.0	69.1	69.9	65.7
Change in the ratio	-0.4	5.5	3.8	2.0	0.8	-4.2
Contributions [2]:						
1. Primary balance	0.8	-3.1	-2.8	-1.9		
2. "Snow-ball" effect	1.1	-0.2	-1.1	-1.8		
<i>Of which:</i>						
Interest expenditure	2.2	2.3	2.2	2.0		
Growth effect	-1.1	-1.9	-2.3	-2.5		
Inflation effect	0.0	-0.5	-0.9	-1.3		
3. Stock-flow	-0.4	6.9	7.7	5.7		
<i>Of which:</i>						
Highway loan	0.0	5.8	5.5	5.2	4.9	0.0

Notes:

[1] End of period.

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

Source: Economic Reform Programme (ERP) 2015, ECFIN calculations

3.4. STRUCTURAL REFORMS

The programme emphasises the importance of reinforcing fiscal policy measures with structural reforms. The ERP gains in consistency, linking the reform agenda with the overarching priorities of the fiscal policy (i.e. sustainability of public finances, to reduce the tax burden and to improve business environment and competitiveness), complemented with additional measures for improving the stability of the financial sector and labour market conditions.

Four key obstacles to economic growth are well identified in this part of the programme, and structural reforms sorted into two groups; addressing macroeconomic obstacles, concerning the fiscal and the financial system stability, and obstacles of sectorial or microeconomic nature, relating to the labour market and the business environment.

The estimation of the budgetary impact of the reforms appears particularly difficult. Although more complete than in the past and extending the coverage of the budgetary impact to the outer years too (in particular for labour market reforms), the programme still fails to present an estimate for parts of the reform agenda, in particular for the financial sector and business environment reforms.

Table II.3.3:

Net direct budgetary impact of key reform commitments (in EUR million)			
	2015	2016	2017
I. Macroeconomic reforms			
a) Fiscal stability measures	21.9	24.2	24.7
- Tax reform	24.9	24.9	24.9
- Public sector wages reform	n.a.	n.a.	n.a.
- Pension system (indexation)	-2.0	n.a.	n.a.
- Healthcare system reform	-1.0	-0.7	-0.2
b) Financial stability measures	n.a.	n.a.	n.a.
- Voluntary financial restructuring project (<i>Podgorica approach</i>)	:	:	:
- Further legislative harmonisation with EU	:	:	:
- Improving cooperatin with other EU supervisors	:	:	:
II. Sectorial or microeconomic reforms			
c) Labour market measures	-12.0	-13.9	-14.2
- Active employment policy	-3.2	-4.6	-4.9
- Social protection of unemployed persons	-9.6	-9.6	-9.6
- Labour law (amendments)	0.8	0.3	0.3
d) Business environment measures	n.a.	n.a.	n.a.
- Privatisation and SOE restructuring	:	:	:
- Public administration reform	:	:	:
- Improving contract enforcement	:	:	:
- Highway (Smokovac-Matesevo section)	-206.0	-206.0	-206.0
Total impact on the budget	-196.1	-195.7	-195.5
Total impact on the budget (in % of GDP)	-5.5	-5.2	-4.9

Source: *Economic Reform Programme (ERP) 2015*

Long term fiscal stability remains the first critical issue –given the absence of monetary policy– to respond to external shocks, promote economic growth and obtain better conditions when tapping capital markets. As already mentioned, the very expensive road project makes fiscal constraints more acute. Apart from the 2015 tax reform, the programme reviews fiscal measures adopted in the past and contributing to reinforce budget revenue performance at present. Another measure is the rationalisation of public sector wages (including in municipalities and state-owned companies) in order to remove disparities. This measure is announced as budgetary neutral and it is expected to be implemented in 2016.

However, there is also a need to improve the budget's expenditure side, in particular through the reform of the pension system in view of the ageing population and its substantial weight on the budget. Yet, the pension reform discards a revision of the current indexation method and opts instead for studying the possibility of supporting individual participation into the system, together with the introduction of further restriction for early retirement. In practical terms, the introduction of the second pillar appears unrealistic until budget constraints are more relaxed, in order to enable the financing of the transition phase between the pay-as-you-go and the capitalisation systems. Introducing restrictions for early retirement appears as an adequate although overdue measure to reduce the large number of pensioners currently below the legal retirement age. The measure could gain in efficiency by also introducing provisions to incorporate pensioners back into the labour market. The ERP also presents an update of the ongoing reform of the health care system to improve its cost efficiency. This policy, while reinforcing the sustainability of the social security system, will limit its negative impact on the overall cost of employment by combining with a similar and simultaneous reduction on the personal income tax (paid by employers).

The ERP reflected on further decentralisation of competences towards municipalities. However, this measure concerning the transfer of education, primary health, and social welfare responsibilities from the central government to those municipalities appraised with sufficient resources has since been disavowed by the authorities for practical reasons. Such a measure could easily result in a multiplication of local staff to administer the new responsibilities transferred, raising the potential for budgetary slippages and/or funding shortfalls when many municipalities are already indebted. Moreover, this kind of decision is very difficult to reverse once started, calling for very cautious consideration before implementation.

High risk premium and access to finance appears as the second obstacle to growth. The credit risk resulting from the still high share of impaired loans in some banks portfolios challenges the stability of the financial system, but also, the credit ratings of the country. Moreover, the issue appears particularly concentrated on the corporate⁽¹⁾ sector. The authorities present as key resolution measure a law on voluntary financial restructuring of debts to financial institutions (expected to be adopted by the parliament in early 2015) to encourage out-of-court resolution of debts. This measure will be complemented with further strengthening of the capital base and liquidity position of banks, indispensable for efficient resolution of NPLs through loss provision in line with Basel III compliant EU legislation, and further reinforcement of banks supervision. The central bank will continue monitoring interest rates developments and, if considered necessary, it may propose to the government specific steps for setting upper limits on lending interest rates for households and companies. However, these caps might also prove counterproductive by actually further limiting lending to SMEs. To speed-up court proceedings and collateral execution, the government sent to the parliament a bill amending the Law on Enforcement and Securing of Claims, to replace the current three-judge panel by individual judge's decision. A budgetary estimate of these measures is not provided.

The programme identifies insufficient flexibility as the key challenge of the labour market. The rigidity of the collective agreements –in particular on wage bargaining and conditions for dismissal– is seen as the key factor behind high unemployment. Employers' preference for foreign workers also points to some domestic labour issues, like the lack of required profiles, experience and training. The ERP

(¹) Households' risk is lower due to the fact that the law allows creditors to seize wages to recover debts

discards education as a decisive factor behind the mismatch between labour supply and demand, signalling the persisting demand for non or semi-qualified workers (e.g. agriculture, construction and tourism), and the fact that demand for professions with secondary, lower tertiary and higher education remains lower than the supply. Nevertheless, to address these issues, the programme proposes to develop qualifications matching market needs, and life-long learning and education of adults programmes, as well as to increase flexibility and mobility by improving the legislative framework, and to reinforce active labour market policies' monitoring, evaluation and funds (the total budget for these would double, from EUR 3.2 million in 2014 to EUR 7 million in 2017). Preparation of a new Labour Law introducing some further flexibility has been announced; although, details remain unknown.

Despite recent progress, there is room for further improvement in the business environment. The ERP identifies in this part three priorities to be addressed: faster and cheaper delivery of construction permits, more efficient contract enforcement, and simplification of legislation. The specific steps for their application are well detailed in the programme, and comprehensively linked to specific priority projects for their implementation. Some other measures with an impact on the overall economy (like the 'Podgorica Approach', fiscal incentives to investors or the highway) are reviewed under business environment too. A third and larger group of policy actions may be classified under public sector reforms. They concern e-government measures (like electronic registration of enterprises or tax payments), integrating in the e-government programme the one-stop shops established in municipalities for delivery of construction permits and registration of enterprises, and continuation of the regulatory impact assessments (RIA) as well as the implementation of recommendations for simplification of legislation (i.e. 'regulatory guillotine'). The programme also presents a quick overview of the privatisation plan for 2015, and announces the imminent adoption of the Law on Public-Private Partnership (PPP) together with the establishment of an Agency for Investments to manage and centralise future infrastructure and public services concessions. There are no estimates of the budgetary impact of these business environment enhancing measures, although some, like the highway or privatisations, already provide some estimates in the ERP's budget tables.

3.5. IMPLEMENTATION OF THE 2014 POLICY GUIDANCE

A new and important part of this year's programme concerns the stocktaking on the six targeted policy guidelines set out in the conclusions adopted by the Joint Ministerial dialogue of 6 May 2014. However, the results show that implementation is still far from completion (see box). Only a few recommendations have been implemented so far, like the preparation of a strategy for introducing ESA2010 accounting standards, the submission of fiscal notifications or the reduction of municipalities' construction fees. Some are still at a preliminary phase of development, like the reform of public sector wages and of the education systems. Others, like the law on voluntary restructuring of debts (i.e. Podgorica approach), the implementation of the regulatory guillotine and the resolution of the aluminium company are delayed. In one case, the reform of the pension indexation system has been discarded, and authorities consider instead the possibility of an overhaul of the system by raising individual contribution. There was no progress concerning the introduction of distinct collective agreements for public and private sectors. Pending negotiations on sectorial collective agreements, labour market flexibility would be addressed by means of a new Labour Law instead. So far, additional adjustment measures have been taken to limit the impact of the financing of the highway on public finances. The ERP mid-term framework will offer an effective benchmark to evaluate public debt and deficit trajectories as well as fiscal rules implementation.

Box : Implementation of the 2014 Policy Guidance

1. *Steer public debt into a downward trajectory by taking additional adjustment measures required to limit the impact of the financing of the highway on public debt and implement effectively the law on Budget and Fiscal Responsibility. In order to improve the transparency of public finances, Montenegro is invited to adopt in 2014 a strategy for implementing the European System of Accounts (ESA2010) and submit fiscal notifications.*
 - The 2015 budget targets a deficit of 5.3% of GDP and public debt will reach 70% of GDP in 2018 due to the financing of a highway. To limit the impact on fiscal stability, the government has adopted a tax reform reinforcing the revenue side of the budget, advances a reform of the public sector wage structure and considers further review of the pension system (see below). The mid-term framework accompanying the 2015 budget presents a deficit reduction programme (in line with Montenegro's fiscal rules) to correct the excessive deficit by the end of 2018. In 2019, once the construction is over, public debt is planned to start declining (by 4% of GDP). Future assessments of budget performance against the ERP mid-term budgetary framework may offer a benchmark to assess Montenegro's capacity and commitment to reduce fiscal imbalances.
 - Work is in progress concerning the implementation of ESA2010 standards in order to improve transparency of public finances. In October 2014, Montenegro submitted for the first time Excessive Deficit Procedure (i.e. Fiscal Notification) tables to Eurostat, which assess the preparatory work of Montenegrin statistical authorities in the EDP statistical framework, including for participating in the ESA 2010 Transmission Programme. Montenegro has prepared a detailed action plan for aligning Government Finance Statistics (GFS) with ESA standard within 18 months.
2. *Prepare, as a first step, a review of the old-age pension indexation system, and implement the plan on restructuring of the public sector as well as the reform of public sector salaries to remove disparities across public bodies.*
 - The pension reform discards a revision of the current indexation system and opts instead for a rather vague review of individual participation into the pension system. The programme also announces the elimination of early retirement benefits without further details.
 - The adoption of a common comprehensive legal framework for calculating public sector wages for all public administrations (including municipalities and public companies) is underway, but some delays could be expected as the draft law wage parameters are being reviewed again.
3. *Further improve the predictability and simplification of the regulatory business environment, notably through the so-called "regulatory guillotine", and reduce the costs of municipal fees on construction permits without endangering the sustainability of local governments' finances.*
 - The implementation of the regulatory guillotine project is on-going albeit delayed. Out of 1,446 recommendations, 63% have been implemented, additional 12% are expected to be adopted in 2015, and the remaining 20% are estimated to be completed before end 2017.
 - Construction permits fees were reduced, and in February 2015, the parliament adopted amendments to the real estate tax, raising local governments' minimum tax rate to 0.25% (and up to 0.5% maximum) of the market value, compared to previous 0.1% tax rate.

4. *Pursue the reform of education, with a view to better aligning education and skills with labour market needs and strengthening cooperation between education and business. Introduce more flexibility in the labour market through distinct collective agreements for public and private sectors.*

- The programme for job-skills training of university graduates continues, and preparation for extension to secondary school graduates also is underway. Concerning secondary and higher vocational education, the ERP announces the national qualification framework establishing a mechanism for evaluating needed skills and qualifications containing measures foreseen for implementation by 2018.
- There was no progress concerning the establishment of two separate general collective agreements for public and private sectors. The General Collective Agreement applies when no Sectorial Collective Agreement is in force. Currently, some of these sectorial agreements need to be revised and for some, negotiations are on-going. Meanwhile, the government will address labour market flexibility by way of advancing the adoption of a new Labour Law. However, details remain unknown.

5. *Implement the planned voluntary financial restructuring programme (the so-called "Podgorica approach") to address the high burden of non-performing loans on bank balance sheets from both a stock and flow perspective.*

- The law is ready but lingers in parliamentary procedure. It was expected to be adopted in the first quarter of 2015 but further delays cannot be excluded. According to the draft law, its implementation would start eight days after its publication on the Official Gazette.

6. *Find a sustainable solution for the aluminium company KAP.*

- The company was liquidated and its assets divided into nine parts and sold to private investors. However, there are problems in the implementation of the sales contract of the largest part, the aluminium smelter. The new owner has paid half the sales price and obtained from the bankruptcy administrator a delay for disbursing the remainder until 10 September 2015, expecting that one of the previous owners withdraws in the meantime the lawsuits against the company.

3.6. THE 2015 POLICY GUIDANCE

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning part I of the ERP, Participants hereby invite Montenegro to:

1. Sustain the commitment to fiscal discipline, establish a credible track record on the basis of the new rules-based fiscal framework and revise the public debt management strategy to bring the public debt into a downwards trajectory in line with the ERP medium-term framework. In this context, municipalities are also called to contribute by strengthening their own budgetary position. In order to improve transparency, develop the necessary administrative capacity to implement the European System of Accounts (ESA2010).

2. Consider additional reforms for attaining long-term sustainability of the budget, such as the introduction of further restriction for early retirement and the consideration of options for individual participation into the old-age pension system on a mandatory basis, as well as the implementation of a common policy for public sector wages in the context of rationalisation and modernisation of the public sector.
3. Implement the planned voluntary financial restructuring programme (the so-called "Podgorica approach") to address the high burden of non-performing loans on bank balance sheets from a flow perspective. In order to address the NPL stock issue, improve deadlines and efficiency of contract enforcement. Introduce effective supervision of factoring companies to improve the transparency of the financial system.
4. Amend labour legislation in order to introduce further market flexibility. Reinforce sanctions to discourage undeclared work. Better target active policies for workers at risk of losing their employments and enhance labour market participation in view of an ageing population.

Concerning part II of the ERP, Participants invite Montenegro to:

5. Actively continue education reform with a view to better aligning education and skills with labour market needs, and strengthening cooperation between education and business.
6. Strengthen the transport development strategy ensuring alignment with the regional agenda on connectivity, with a particular focus on the core investment priorities (core network), and establish a credible planning and funding mechanism in the form of a single sector pipeline.
7. Further improve the business environment by ensuring the timely implementation of the so-called "regulatory guillotine" (simplification) project, enhancing the functioning of one-stop shops at municipal level for the issuing of construction permits and the quality of the land registry.
8. Make further progress with a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU. Efforts in this direction should commence with those products where preparations are advanced and where Montenegro sees the biggest export potential.

Annex: Overall assessment of programme requirements

Montenegro's first Economic and Reform Programme (ERP 2015-2017), replacing previous Pre-accession Economic Programmes (PEP), was submitted on 30 January 2015. This year's submission has gained in consistency, presenting a systematic approach to identify macroeconomic imbalances, and articulating a fiscal framework in accordance, reinforced by structural reforms. The ERP status has been enhanced, and it is introduced as the work programme of the government as well as an integral part of the EU accession process. Moreover, the macroeconomic and fiscal baseline scenarios appear broadly consistent with Montenegro's annual budget.

Macro framework

The programme presents a clear and concise picture of past economic developments. Overall, data is substantially more detailed than last year's PEP, with almost all annex tables completed. Although still incomplete, there are now some labour data projections, which used to be empty in the past. Yet, the persistent absence of private external debt statistics still hampers the external sustainability analysis. In response to last year's assessment, the ERP presents the external assumptions underlying its macroeconomic projections. The competitiveness (REER) analysis in this year's programme has been fine-tuned, using monthly data instead of annual, and adding one more trade partner. However, the case study it provides focuses only on tourism competitiveness. The baseline framework appears coherent, consistent and sufficiently comprehensive, and the programme offers a comparative (albeit very basic) review of the low-growth scenario.

Fiscal framework

The fiscal framework appears well integrated in support of the overall policy objectives. With respect to the country accession perspective, there is also a clear effort to align the legislative and budgetary frameworks with the EU, like the action plan for introduction of ESA2010 or the presentation of Fiscal Notifications (i.e. EDP tables). However, the adoption of numeric fiscal rules may appear as merely formal unless followed –in future programmes– by proof of coherent implementation. The fiscal scenario is coherent with the medium-term economic framework. However, the annual financing cost of the highway seems but a rough estimate, and probably overestimated for 2015. The key measures on the revenue and expenditure sides are well explained, and their budgetary impact has been provided for almost all tax reform measures.

Structural reforms

The presentation of the obstacles to growth as well as the measures are clearly defined, offering an improvement compared with previous programmes. The programme also refers –in order to define its priorities– to remarks in the Progress Reports, the conclusions of the Joint Ministerial dialogue of May 2014, and to the IPA Indicative Strategy Paper (2014-2020). The coherence of the programme is also reinforced in the context of EU accession perspective. Thus, measures and structural reforms, notably when foreseeing the adoption of new legislation, systematically consider its alignment with the EU legal framework. However, the coherence of the chapter is partially lost on the summary table, providing incomplete estimates of the budgetary impact for several reforms.

4. SERBIA

4.1. EXECUTIVE SUMMARY

Hit by heavy floods in the spring and a weaker external environment, Serbia's economy entered another recession in 2014. Economic growth is expected to remain modest and the programme foresees a mild recession continuing in 2015, followed by a moderate recovery. Domestic demand is forecast to be a drag on growth in the short term and the rebalancing of the economy away from consumption is set to continue, while investment and exports are seen as the key drivers of economic activity. A sustainable reduction of labour market imbalances would likely be protracted, as investment gathers speed from a relatively low level. Price stability is expected to be preserved as fiscal consolidation measures and weak credit suppress demand and reforms reduce risk premia and exchange rate volatility. External imbalances are set to decline but are likely to remain structurally high. The macroeconomic scenario is plausible and risks to it are clearly identified, although the level of uncertainty facing Serbia's economy remains very high.

Fiscal imbalances increased as the slow pace of reforms continued to weigh on the budget. However, the 2014 budget deficit of 6.7 % of GDP was lower than planned in the initial and the supplementary budgets, reflecting under-execution of capital expenditure and social expenditure savings due to delays in the restructuring of public enterprises. The programme targets an expenditure-based fiscal consolidation aimed at stabilising government debt by 2017 and facilitating a rebalancing of the macroeconomic policy mix. The budget deficit is forecast to fall to 3.8 % of GDP in 2017, implying a reduction in primary expenditure of 7.9 % of GDP. The fiscal scenario is plausible and the proposed consolidation measures are frontloaded and largely appropriate. However, despite a strong consolidation effort, government debt will most likely continue growing and additional efforts and strict control over new government guarantees will be required to limit further debt increases.

The programme clearly recognises the major structural obstacles to growth. These are mostly unchanged from the previous year and include excessive state influence in the economy, an underdeveloped private sector, administrative and regulatory barriers to business, poor infrastructure, low investment, large informal economy and insufficient competition in some sectors. There is also an understanding of the urgency of tackling structural problems and of the need to accelerate the implementation of reforms in order to support a sustainable economic recovery and reduce macroeconomic and fiscal imbalances. To this end, the programme outlines an ambitious reform agenda aimed at restructuring state owned enterprises, streamlining and improving the performance of public administration, improving the business environment, and strengthening financial stability.

In line with the targeted policy guidance set out in the conclusions of the Joint Ministerial dialogue in 2014, Serbian authorities have already taken important steps to start implementing recommended reforms. They have advanced strong fiscal consolidation measures, including pension and public sector wage cuts. As a result of extensive amendments to the labour law and to the pension and disability insurance law, adopted last year, early retirement has been made actuarially fairer and the legal retirement age for women and the general minimum retirement age are set to increase gradually. The process of dealing with construction permits has been simplified and shortened and legislative changes have given a new impetus to the process of restructuring publicly owned enterprises. Amendments to bankruptcy regulations and proceedings aim to improve the overall business environment.

4.2. ECONOMIC OUTLOOK AND RISKS

Economic growth is expected to be modest. Real GDP contracted in 2014, mostly due to the damage and disruption caused by heavy spring floods and because of weak external demand. The programme foresees the continuation of a mild recession in 2015, followed by a moderate recovery. Government consumption is forecast to fall by more than 16 % over the programme and fiscal consolidation efforts to curtail the growth of domestic demand. The decline of private consumption is expected to deepen in the first year of the programme before turning to growth, influenced by planned public sector reforms and the recent cuts in pensions and government sector wages. Investment and exports are seen as the only drivers of economic growth, increasing on average by around 5 % per year in the period 2015-2017.

Ambitious fiscal consolidation and structural reforms are seen as contributing to the reduction of macroeconomic imbalances. Subdued demand and a relatively stable exchange rate underpin programme expectations for preserving the low inflationary environment, with inflation returning within the central bank tolerance band by mid-2015. The planned structural reforms are forecast to temporarily push unemployment up in the first year of the programme. The authorities expect growing investment and effects from recently improved labour regulations to lift employment creation, bringing the unemployment rate down as early as 2016. According to the Commission's forecast, however, the sustainable reduction of labour market imbalances and gains in official employment would likely take more time, as investment slowly gathers speed from a relatively low level. The programme forecasts improvements in the trade balance to outweigh growing interest payments, contributing to a further narrowing of the current account deficit.

Table II.4.1:

Macroeconomic developments and forecasts

	2013		2014			2015		2016		2017	
	COM	ERP	COM	ERP	Actual **	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	2.6	2.6	-2.0	-2.0	-1.8	-0.3	-0.5	1.2	1.5	n.a.	2.0
<i>Contributions:</i>											
- Final domestic demand	-3.2	-3.0	-1.8	-2.0	-1.4	-1.4	-2.7	0.5	0.9	n.a.	1.6
- Change in inventories	0.6	0.8	-0.2	0.0	-0.2	0.1	0.0	0.0	0.0	n.a.	0.0
- External balance of goods and services	5.2	4.8	0.0	0.0	-0.1	1.0	2.2	0.7	0.6	n.a.	0.4
Employment (% change)	3.7	3.7	4.3	3.5	4.8	-1.9	-2.0	-0.6	0.0	n.a.	1.0
Unemployment rate (%)	22.1	22.1	19.6	20.0	18.9	21.4	21.3	21.8	20.9	n.a.	19.8
GDP deflator (% change)	5.4	5.4	1.9	2.2	1.9	2.5	2.7	3.3	4.1	n.a.	4.1
CPI inflation, annual average (%)	7.8	7.8	2.1	2.1	2.1	3.2	2.7	4.3	4.0	n.a.	4.0
Current account balance (% of GDP)	-5.6	-6.1	-5.8	-6.1	-5.5	-5.3	-4.7	-5.4	-4.5	n.a.	-4.3
Budget deficit (% of GDP)*	-4.7	-5.3	-4.5	-7.9	-6.7	-4.9	-5.9	-3.9	-4.7	n.a.	-3.8
Government debt (% of GDP)	59.4	61.1	69.5	69.9	72.4	76.9	77.7	81.0	79.2	n.a.	78.7

Sources: Economic Reform Programme (ERP) 2015; Commission Winter 2015 Forecast

* Budget deficit data are not comparable due to a recent change in national methodology

** The latest available information and Commission estimates

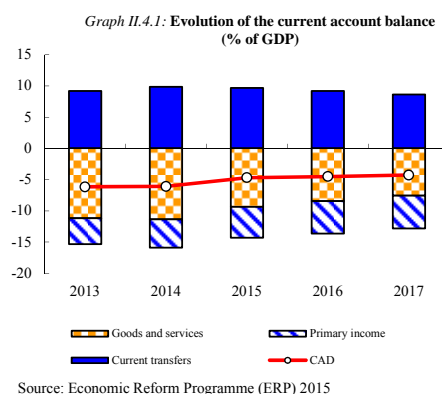
The macroeconomic scenario is plausible and risks are clearly identified. In addition, the programme presents an alternative scenario on the assumption that some of the risks, like delaying structural reforms and weaker growth of the EU economies, materialise. This is expected to lead to lower investment, weaker exports, and a markedly deeper recession in 2015 (-3 %), followed by a marginal recovery (real GDP growth of 0.5 % in 2016 and 1.0 % in 2017). Risks to the baseline macroeconomic scenario are partly offset by upside risks such as the possible successful resolution of the restructuring of several big companies in the chemical and metal industries. The big difference in growth in the different scenarios, however, is symptomatic of the very high levels of uncertainty still facing the Serbian economy.

Domestic demand is foreseen to be a drag on growth in the short-term and the rebalancing of the economy away from consumption is set to continue. However, the programme forecasts a bigger decline in public consumption than the Commission, assuming a stronger impact of reforms on it. In 2015, this is expected also to lead to a fall in imports. Export growth is initially forecast to remain subdued but to pick up as the effects of the floods fade away and the recovery in Serbia's main trading partners gathers pace. Although facing significant risks from the external environment, investment prospects look more solid. Having reached their lowest level in years, they are forecast to expand, supported by stronger government capital expenditure and the recently-adopted and newly-planned structural reforms facilitating a better business environment. A number of big infrastructure projects in the transport and energy sectors could additionally boost their performance.

Weak demand is likely to remain a major disinflationary factor throughout most of the programme period. Inflation has been extremely low and for about a year it has even stayed below the central bank's tolerance band. Price stability is expected to be preserved as fiscal consolidation measures and weak credit activity suppress demand and the implementation of reforms reduces risk premia and exchange rate volatility. Nevertheless, domestic prices would still be subject to pressure and uncertainty stemming from further adjustments to administered prices and from food price dynamics. Fiscal slippages, reform delays or geopolitical tensions could potentially also fuel exchange rate and inflation volatility. On the other hand, steady implementation of the announced reform measures could help further anchor inflation expectations at the targeted levels, strengthen the credibility of the inflation targeting regime and stabilise the exchange rate, promoting further dinarisation of the economy.

External imbalances are set to decline but are likely to remain structurally high.

According to the programme, increased public sector savings would be one of the main drivers of the envisaged further reduction of the current account deficit. The fall in external imbalances is expected to be more visible in the first year of the programme, supported also by recent gains in price competitiveness, but will slow down significantly thereafter as domestic demand and imports progressively strengthen. Importantly, structural reforms are expected to contribute to boosting export competitiveness by curbing labour costs and improving productivity. However, exports are subject to non-negligible risks, not only from the external environment but also from the insufficient diversification of production and dependency on a single car producer. In addition, some of the recently announced big foreign investment projects in non-tradable sectors could potentially increase external indebtedness without expanding the export base, thus weakening external sustainability.



The net international investment position may deteriorate further. External government borrowing continued to drive the expansion of the international investment position deficit, while deposit-taking corporations decreased their net foreign liabilities in 2014. Net FDI increased by around 10 %, mostly in the segment of reinvested earnings, covering close to two-thirds of the current account deficit. In view of the envisaged evolution of the current account deficit and expected FDI inflows over the programme horizon, Serbia's external indebtedness will likely continue growing. However, a recently-agreed new arrangement with the IMF will anchor stability-oriented policies, while a comfortable level of official foreign exchange reserves would serve as a buffer and help manage external risks.

The banking system still faces a number of challenges. Financial intermediation was revived by another programme of government subsidised lending in 2014. Still, credit growth, especially to the corporate sector, remained anaemic. By contrast, commercial banks' net claims on government continued expanding strongly, reflecting the government's growing financing needs. Bank recapitalisations and

bankruptcies over the last few years have continued to put pressure on the budget and led to the establishment of a new bank resolution mechanism through amendments to the law on banks and other legislation. Mirroring the difficult economic environment, non-performing loans increased to 23.1 % in October 2014. However, they were fully provisioned and the banking system as a whole remained well-capitalised and liquid. Commercial banks continued to reduce their net foreign liabilities but the effects from deleveraging seem manageable and have been softened by a steadily expanding domestic deposit base.

Table II.4.2:

Financial sector indicators

	2010	2011	2012	2013	2014
Total assets of the banking system, mEUR	33,194	36,015	35,163	34,836	35,532
Credit growth	32.3	5.5	12.9	-6.5	-2.8 Q3
Deposit growth	14.4	9.2	10.4	3.3	5.5 Q3
Loan to deposit ratio	1.2	1.4	1.3	1.4	1.2
Financial soundness indicators					
- non-performing loans	16.9	19	18.6	21.4	23.0 Q3
- total provisions to gross NPLs	149.4	129.2	126.5	117.9	118.6 Q3
- regulatory capital to risk weighted assets	19.9	19.1	19.9	20.9	19.4 Q3
- liquid to total assets	35.1	37.8	34.5	38.5	37.3 Q3
- return on equity	5.3	0.2	2	-0.4	4.6 Q3
- forex loans to total loans*	76.8	69.8	74.1	71.6	70.3 Q3

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

4.3. PUBLIC FINANCE

Fiscal imbalances increased as the slow pace of reforms continued to weigh on the budget. The overall deficit expanded to reach 6.7 % of GDP⁽¹⁾ in 2014. The spring floods, early parliamentary elections and the unforeseen economic contraction delayed reforms and had a negative impact on the budget performance. However, the soaring budget deficit reflected mainly higher spending on interest payments, activated government guarantees and expenses, related to bail-outs of failed state-owned banks and of loss-making public enterprises. Total expenditure rose by 3.3 percentage points to 48.5 % of GDP. The share of spending on wages and salaries and pensions in GDP have broadly stabilised as a result of limited indexation, employment restrictions and outright pension and wage cuts which were implemented in December. Still, most of the other expenditure, notably payments on goods and services, subsidies and interest payments increased.

However, the 2014 budget deficit was lower than planned in the initial and the supplementary budgets. The better-than-expected outturn came as a result of under-execution of capital expenditure and of social expenditure savings due to delays in the restructuring of public enterprises. Following a slow start at the beginning of the year, revenue performance improved in the second half of the year, turning out better than envisaged in the revised budget. Total revenue rose by around 2.1 percentage points to 41.8 % of GDP. Tax hikes, including an increase of the reduced VAT rate from 8 % to 10 % since the beginning of 2014, excise changes, and inroads in reducing the grey economy, underpinned the growth in tax revenues despite the weak economy.

The programme targets an expenditure-based fiscal consolidation aimed at stabilising government debt by 2017 and facilitating a rebalancing of the macroeconomic policy mix. Over 2014-17, the

(¹) The law on the 2015 budget has introduced changes in the budget deficit methodology. Expenditures on activated government guarantees, bank recapitalisations and assumption of debt of public enterprises are now counted as budget expenditure, not as financing operations as before. The text comments on the actual execution data for 2014 which differ from those in the ERP.

budget deficit is forecast to fall by 4.2 percentage points to 3.8 % of GDP, based on a significant reduction in primary expenditure of 7.9 % of GDP. The envisaged adjustment is front-loaded, with most of the measures having an effect as early as 2015. Fiscal consolidation should also create the necessary space for further monetary policy easing. A protracted recovery of private consumption and a revenue-poor structure of economic growth, relying on exports and investment, are expected to curb revenues. General government revenue is, therefore, foreseen to steadily fall over the programme period by 2.8 % of GDP in total. The authorities are forthcoming in recognising that despite the planned significant reduction in the deficit, further consolidation measures would be needed after 2017 in order to restore debt sustainability.

The budget deficit is foreseen to come down significantly in 2015, although at 5.8 % of GDP, it will remain very high. The 2015 budget is based on a sizeable current expenditure retrenchment. Important savings are expected from the cuts in pensions and public sector wages,⁽¹⁾ implemented in December 2014. A number of other measures, ranging from pension and wage freezes, reduced employment in the public sector, lower subsidies, changes in procurement rules, and reforming public enterprises are envisaged to bring additional savings. Although expenditure measures dominate the consolidation effort, revenues should also receive, indirectly, a boost from an increased gas transportation fee. In addition to the envisaged structural adjustment, effects from the expiration of one-off measures (recapitalisation of banks and state-owned enterprises, assumption of debt of other entities) are expected to lead to lower spending. They are planned to outweigh by far one-off reform costs (severance pay and unemployment benefits), related to public enterprise restructuring and reduction in government employment. Although some of the newly created fiscal space will be eaten up by rising interest payments, consolidation measures would also leave more room for capital spending, which is set to increase by 0.5 % of GDP.

Table II.4.3:

Composition of the budgetary adjustment (% of GDP)

	2013	2014 actual	2014	2015	2016	2017	Change: 2014-17
Revenues	39.7	40.9	41.8	40.3	39.1	38.2	-2.8
- Taxes and social security contributions	35.3	36.5	37.1	35.3	34.2	33.3	-3.2
- Other (residual)	4.4	4.4	4.7	5.0	4.9	4.8	0.4
Expenditure	45.0	48.9	48.5	46.1	43.8	41.9	-6.9
- Primary expenditure	42.6	45.8	45.5	42.6	39.9	37.9	-7.9
<i>of which:</i>							
Gross fixed capital formation	2.2	2.6	2.5	3.1	3.1	3.0	0.4
Consumption	18.1	18.4	18.4	17.1	16.0	14.9	-3.4
Transfers & subsidies	20.3	21.1	21.0	20.4	19.0	18.3	-2.8
Other (residual)	1.9	3.7	3.6	2.0	1.8	1.6	-2.1
- Interest payments	2.4	3.0	3.0	3.5	3.9	4.0	1.0
Budget balance	-5.3	-7.9	-6.7	-5.8	-4.7	-3.8	4.2
- Cyclically adjusted	-5.8	-7.5	-	-5.0	-4.3	-3.9	3.6
Primary balance	-2.9	-4.9	-3.7	-2.4	-0.8	0.3	5.2
Gross debt level	61.1	69.9	72.4	77.7	79.2	78.7	8.8

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

The fiscal scenario is plausible and the proposed consolidation measures are largely appropriate, but government debt stabilisation would likely require additional efforts. In addition, possible delays in structural reforms, as observed in previous years, could undermine the achievement of the planned adjustment. The programme outlines an alternative fiscal and debt scenario based on the alternative (more pessimistic) macroeconomic scenario. However, in view of elevated macroeconomic risks and

(¹) A 10 % linear reduction of public sector employees' net salaries above RSD 25 000; pensions were reduced progressively by 22 % between RSD 25 000 and RSD 40 000, and by 25 % over RSD 40 000.

uncertainties, it would have also merit contingency planning of additional consolidation measures. On the positive side, the execution of the budget in 2014 provides a better starting point than expected and any gains from improvements in revenue collection should be used to increase spending on well-targeted investment projects and on further deficit cuts. A more ambitious deficit reduction path, especially after 2015, would be needed to firmly reverse the trend of growing government debt.

There is significant room to improve budgetary processes and to shift to a more growth-enhancing spending structure. Most of the budget expenditure is still consumed by spending on pensions and wages, while much-needed capital expenditure is at a very low level. In recognition of this, the authorities have recently introduced a new rule for the indexation of pensions and salaries which effectively freezes them over the programme horizon, until government spending reaches 7% and 11% of GDP, respectively. However, in order to strengthen policy-making and support a sustainable and fairer reduction of fiscal imbalances, deficiencies in the budgetary process need to be addressed as well. They encompass almost all stages of the process, including statistical coverage, fiscal rules, budget planning and implementation. Therefore, the envisaged public administration and public finance management reforms should be pursued vigorously and dedicated efforts should be put into building adequate institutional, statistical and human resources related to budget management.

Box : The budget for 2015

The parliament adopted the 2015 republican budget on 25 December 2014.

The envisaged consolidation measures are heavily dominated by expenditure cuts. The main adjustment is to come from the already adopted in 2014 reduction in pensions and public sector wages, pension and wage freezes, lower subsidies, and public enterprises reform.

Table: Main measures in the budget for 2015*

Revenue measures	Expenditure measures
A transit fee for gas transportation of RSD 2 per m ³ (leading to lower subsidies to Srbijagas) (0.2-0.3 % of GDP)	Reducing public sector wages and salaries (10 % linear cut on net salaries above RSD 25 000) (-0.5 % of GDP)
Public enterprises reform leading to higher dividend payments to the budget (0.3-0.5 % of GDP)	Reducing pensions (progressively by 22% between RSD 25 000 and RSD 40 000, and by 25% over RSD 40 000) (-0.5 % of GDP)
	Pensions and salaries freeze (-0.1 % to -0.2 % of GDP)
	Reducing public sector employment by 5% annually (most of it through partial replacement) (-0.3 % of GDP)
	Reducing subsidies (-0.2 % of GDP)
	Equalising procurement rules for domestic and foreign suppliers (-0.1 % of GDP)

Total tax revenues effect
(0.5-0.8 % of GDP)

Total expenditure effect
(-1.7 % to -1.8 % of GDP)

* Estimated impact on general government revenue and expenditure.

Source: ERP 2015

Despite strong consolidation efforts, government debt will most likely continue increasing over the programme horizon. Although the programme is more sanguine about it, expecting debt to stabilise below 80 % of GDP, it may actually surpass this threshold in 2016. Already in 2014, government debt went above 70 % of GDP, higher than the level envisaged by the programme. In addition to the primary deficit, a major element to the debt-creating dynamics comes from exchange rate fluctuations. As most of the debt is denominated in foreign currencies, with rising indebtedness, dinar depreciation has an increasingly negative impact on the debt ratio. This was highly visible in 2014, when the dinar lost 5.5 % of its value against the euro and almost 20 % against the US dollar, contributing to a debt increase of around 5 % of GDP. The average dinar depreciation against the euro over the last five years was slightly below 5 %, which even under the foreseen very different external and domestic policy settings gives little credibility to the programme assumption of an average nominal depreciation of 2 % over the 2015-2017 period. With little or even negative contributions from inflation and real GDP growth, growing interest payments are likely to overwhelm them in 2015 and further worsen debt dynamics. Refinancing risks also loom large as gross public financing needs are expected to reach close to 20 % of GDP in 2017.

Strict control over new government guarantees and additional efforts will be needed to limit further debt increases. Government-guaranteed debt, of which about 70 % has already been activated at the cost of about 1 % of GDP in direct annual payments from the budget, is foreseen to increase to 9.3 % of GDP in 2015. The programme targets no new guarantees for public enterprises' liquidity loans and envisages flattening out net guarantees after 2017. These goals should be supported by vigorous reforms and increasing efficiency of public enterprises, especially of those that have absorbed, directly and indirectly, significant state funds over the years. Reversing the trend of rising government debt remains a significant challenge and requires sustained and additional efforts. This is also acknowledged by the programme according to which, under the assumption of continuous deficit adjustment after 2017 and excluding effects from restitution-related debt in the future, it will take until 2030 for government debt to return to the threshold of 45 % of GDP prescribed by the fiscal rule.

Box : Debt dynamics

Government debt is forecast to peak in 2016. Debt-reducing effects from real GDP growth and inflation would remain rather small, while rising interest payments put additional burden on government finances. Consolidation efforts are expected to turn the primary deficit into a small surplus only in the last year of the programme. Stock-flow adjustments are envisaged to be adding less and less to the debt due to the foreseen limited dinar depreciation and restricted issuing of new state guarantees. Restitution-related debt and privatisation inflows from the sale of the state-owned telecom, not included in this scenario, could potentially and temporarily impact in opposite directions debt dynamics as well.

Composition of changes in the debt ratio (% of GDP)					
	2013	2014	2015	2016	2017
Gross debt ratio	61.1	69.9	77.7	79.2	78.7
Change in the ratio	3.0	8.8	7.8	1.5	-0.5
<i>Contributions [1]:</i>					
1. Primary balance	2.9	4.9	2.4	0.8	-0.3
2. 'Snow-ball' effect	-1.9	2.9	1.9	-0.3	-0.5
<i>Of which:</i>					
Interest expenditure	2.4	3.0	3.5	3.9	4.0
Growth effect	-1.4	1.2	0.3	-1.1	-1.5
Inflation effect	-2.9	-1.4	-1.9	-3.0	-3.1
3. Stock-flow adjustment	2.0	1.0	3.5	0.9	0.3

Notes:

[1] 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: ERP 2015, ECFIN calculations

4.4. STRUCTURAL REFORMS

The programme clearly recognises the major structural obstacles to growth. They remain mostly unchanged from the previous year and include excessive state influence in the economy, an underdeveloped private sector, administrative and regulatory barriers to business, poor infrastructure, a low level of investment and a large informal economy. There is also an understanding of the urgency of tackling the structural problems and of the need to accelerate reform implementation in order to support a sustainable economic recovery and reduce macroeconomic and fiscal imbalances. To this end, the programme outlines an ambitious reform agenda aimed at improving the business environment, restructuring state-owned enterprises, streamlining and improving the performance of the public administration, and strengthening financial stability.

The programme foresees continuing the long overdue restructuring of public enterprises. In January, in accordance with the recently adopted law on privatisation, 188 companies from the portfolio of the privatisation agency have been put into a bankruptcy procedure. About 200 companies are expected to be fully or partially privatised, either by equity or asset sales, or through strategic partnership before the end of 2015. In view of the limited time and capacity constraints to process such a large number of privatisations, it seems advisable to target the restructuring of the biggest and most problematic cases first. An appropriate social programme has been put in place for the workers who are expected to lose their job in this process. In addition to the companies from the portfolio of the privatisation agency, the authorities intend to restructure some of the large state-owned companies (Srbijagas, Railways, Electric Power Industry — EPS, and Roads of Serbia). They have been a source of significant market distortions and have also accumulated large obligations, putting a constant burden on public finances. Concrete steps should, therefore, be taken to introduce better corporate governance in these companies and implement organisational and financial restructuring plans as envisaged, in line with the relevant *acquis*, in particular in the areas of energy, transport and state aid. However, as past experience has shown, this process is prone to difficulties and delays and would require a steadfast commitment by the authorities for it to be implemented as planned.

Further reforms to improve the business environment and promote private sector development are needed as well. The programme presents a number of initiatives in support of this goal, including a strategy for small and medium-sized enterprises, a new investment law covering both foreign and domestic investments, rationalisation of investment promotion programmes, improving the work of the innovation fund, regulating the issue of conversion of land use into property rights, intensifying the regulatory guillotine process, and boosting the capacity of the tax administration. However, in most cases, these policy intentions remain vague and need to be further elaborated and specified. In addition, several issues outlined last year, like a better regulation of para-fiscal charges and an overview of all state aid provisions and a comprehensive subsidies reform, have not been raised by the programme, although they still remain highly relevant. In a difficult international environment, privatisation has been at a standstill, recently confirmed again by the failure to conclude a deal on the steel mill in Smederevo. Nevertheless, the announced privatisation of Telecom Serbia and the declared reliance on concessions and public-private partnerships is welcome and should be used to attract additional investments and to spur productivity gains. So far, however, the experience in the implementation of public-private partnerships and concessions has been extremely limited, in part due to capacity constraints of the relevant administration. The reform of the construction permit issuance system entered into force in March and its effective implementation remains to be demonstrated.

The legislative framework underpinning financial stability has been strengthened. Recent amendments to the law on banks and a number of related laws clarified the process of bank resolution and the roles of the different institutions involved in it. In the future, bank shareholders should be the first to cover any potential losses in case a bank falls into financial difficulties. In order to address the issue of the very high ratio of non-performing loans and to improve their collection, the process of settlement of creditor claims has been improved. In this regard, the programme envisages further steps to improve the

legislative basis, in particular with regard to the valuation and treatment of, primarily, real estate collateral, and eventually resolving non-performing loans through their sale or restructuring.

Legislative changes have addressed major labour market deficiencies. The authorities envisage continuing labour market reforms by establishing a legal basis for the operation of temporary employment agencies and leasing of staff, and better regulating labour relations and social dialogue. Employment policy should be strengthened as well in view of the planned adoption and implementation of the EU-driven Employment and Social Policy Reforms Programme and the revision of the National Employment Strategy 2011-2020. Over the programme horizon, however, the labour market is expected to remain tight as the ongoing public sector restructuring puts pressure on unemployment, which is already very high. In this context, increasing the coverage of active labour market policies, as envisaged by the programme, may be an important element of the efforts aimed at containing social pressures and improving the chances of the reforms to succeed. This would, however, require a sound analysis of the nature of underlying labour market deficiencies, a sustained budget commitment, and should be based on a proper evaluation of already existing instruments.

Major public systems like education, public administration and health care are in need of reform. The programme outlines a number of initiatives to advance reforms in these sectors, although many of the proposed measures remain unchanged from last year, indicating little progress since then. In addition, budgetary costs or potential benefits of the proposed measures are not always quantified. Nevertheless, important steps have been taken to prepare the launch of the public administration reform and improving public financial management. A reform of the salary system and introduction of common salary grades, coefficients and promotion rules is expected in 2015. However, the foreseen organisational and functional reviews in several public sectors that are expected to improve their performance and underpin the envisaged fiscal adjustment have not started yet. In addition, the registry of public sector employees that would allow for a better control of the number of employees and the amount of their remunerations is still not complete and may be of limited use in view of its voluntary nature. Following bold amendments in 2014, the pension system reform is set to continue over the programme period with a review of the early retirement conditions for persons working in particularly difficult and hazardous conditions and an assessment of the viability of the pension and disability insurance of farmers.

4.5. IMPLEMENTATION OF THE 2014 POLICY GUIDANCE

In line with the targeted policy guidance set out in the conclusions of the Joint Ministerial dialogue of May 2014,⁽¹⁾ the Serbian authorities have already taken important steps to start implementing recommended reforms. They have advanced strong fiscal consolidation measures, including pension and public sector wage cuts. As a result of extensive amendments to the labour law and to the pension and disability insurance law, adopted last year, early retirement has been made actuarially fairer and the legal retirement age for women and the general minimum retirement age are set to increase gradually. The process of dealing with construction permits has been simplified and shortened, but still needs to be implemented, mainly at the level of local authorities. Legislative changes gave a new impetus to the process of restructuring publicly owned enterprises. In addition, amendments to bankruptcy regulations and proceedings and to the law on banks aim to improve the overall business environment and establish better mechanisms to protect creditors and safeguard financial stability at a lower cost to the budget.

(¹) <http://register.consilium.europa.eu/doc/srv?l=EN&f=ST%209561%202014%20INIT>

Box: Implementation of the 2014 Policy Guidance

1. *Strengthen fiscal consolidation, by taking additional measures to reduce the budget deficit in 2014 and the following years and further support the envisaged medium-term consolidation path by credible public sector reforms. To this end, the authorities are encouraged to implement the public administration and pension reforms planned in the programme, by standardising salary grades for public officials and taking steps to revisit employment in the public sector in a sustainable manner, as well as limiting possibilities for early retirement and gradually increasing the retirement age for women.*

- Strong pension and public wages cuts were implemented in December 2014 and the 2014 deficit outcome at 6.6% of GDP was better than planned in the initial and the supplementary budgets.
- A number of additional consolidation measures, mostly on the expenditure side, are proposed in the medium-term fiscal strategy, aiming to cut the deficit by around 4% of GDP to 3.8% of GDP in 2017.
- Amendments to the law on pension and disability insurance have limited the possibilities for and made actuarially fairer early retirement by increasing the minimum retirement age from 58 to 60 years by 2023, increasing gradually the retirement age for women from 60 to 65 years until 2032 (6 months per year until 2020, 2 months per year thereafter), and introducing a penalty of 4% per year for early retirement.
- Work is under way to introduce common salary grades, coefficients and promotion rules as of 2015 and to reduce public sector employment. However, the planned organisational and functional reviews of several public sectors have not started yet.

2. *Further strengthen public finance management, notably by improving the capacity of the tax administration and the budget process with regards to arrears, which would be instrumental in supporting consolidation efforts.*

The process of introducing electronic filing of tax returns has been finalised and the submission of electronic applications for income taxes was enabled; transaction costs were reduced by allowing the payment of taxes and social security contributions on one account.

3. *Address the high burden of non-performing loans on bank balance sheets.*

- Amendments to the Bankruptcy law aim at accelerating bankruptcy procedures; the programme envisages further steps to improve the legislative basis, in particular with regard to the valuation and treatment of, primarily, real estate collateral, and eventually resolving non-performing loans through their sale or restructuring.

4. *Use the opportunity of the low prevailing rate of inflation to fully cement the central bank's anti-inflationary credentials and thereby anchor medium-term inflation expectations, while investing further efforts in developing and implementing policy measures to reduce inflation volatility.*

- Suppressed domestic demand and delayed adjustments of administered prices have kept inflation very low, below the central bank target tolerance band. However, no specific measures were taken to reduce inflation volatility.

5. *Adopt the necessary legislation and complete, as outlined in the programme, the restructuring process of state-owned enterprises; review the efficiency of all forms of state aid and take steps to reduce subsidies and state guarantees, and improve governance, in particular in large loss-making state-owned enterprises.*

- In accordance with the recently adopted law on privatisation, 188 companies from the portfolio of the Privatisation agency have been put into a bankruptcy procedure. In addition, about 200 companies, currently exempted from state aid rules, are expected to be fully or partially privatised, either by equity or asset sales, or through strategic partnership before the end of 2015. However, this process is prone to difficulties and delays and would require a steadfast commitment by the authorities to be implemented as planned. Subsidies for big land-owners and public broadcasting companies are planned to be completely abolished, while subsidies for Serbian railways to be reduced. There was no review of state aid schemes and no reported steps to improve governance in large loss-making state-owned enterprises.

6. *Improve the business environment and support private sector development, notably by reducing the scope of para-fiscal charges and simplifying the regulatory environment ('regulatory guillotine') and the process of dealing with construction permits.*

- Amendments to the law on planning and construction simplified and shortened the process of dealing with construction permits. No measures were reported on reducing the scope of para-fiscal charges and simplifying the regulatory environment.

7. *Increase labour market flexibility and reduce rigidities by extending the maximum duration of short-term employment, linking severance payments to the number of working years with the current employer, and simplifying the structure and calculation of salaries and compensations.*

- Amendments to the Labour law have addressed these issues by extending the maximum duration of short-term contracts from one to two years, linking severance payments to the number of working years with the current employer, and simplifying the structure and calculation of salaries and compensations. In addition, the process for extending collective agreements was changed and cases for dismissal were clarified and streamlined.

4.6. THE 2015 POLICY GUIDANCE

**Joint conclusions of the Economic and Financial Dialogue
between the EU and the Western Balkans and Turkey**

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning part I of the ERP, Participants hereby invite Serbia to:

1. Strengthen fiscal consolidation by using any excesses revenue and current expenditure savings to further reduce budget deficits in 2015 and the following years. Underpin the medium-term consolidation path by implementing the planned structural reforms.
2. Advance the restructuring and privatisation of state-owned enterprises, prioritising the biggest companies. Introduce better corporate governance and advance, as planned, the organisational and

financial restructuring of large, loss-making utilities. Review the efficiency of all forms of state aid and take steps to reduce it. Proceed to revisit public sector employment in a sustainable manner by implementing the Action plan on public administration reform.

3. Further strengthen public finance management, notably by improving the budgetary process and the capacity of the tax administration. Compile and start submitting to Eurostat excessive deficit procedure notification tables before the end of 2015.
4. Advance with the rebalancing of macro-economic policies with fiscal consolidation as a pre-condition for a more accommodative monetary policy stance, with a view to fostering a pick-up in the pace of credit extension. In this context, increased efforts to address the high burden of non-performing loans on banks' balance sheets, involving all key stakeholders including the central bank as necessary, also appear warranted.

Concerning part II of the ERP, Participants hereby invite Serbia to:

5. Improve the business environment and tackle the grey economy, notably by better regulating para-fiscal charges, business inspections, and leasing of labour. Take steps to further simplify the regulatory environment by re-launching the "regulatory guillotine".
6. Adopt a comprehensive and well-targeted set of active labour market policies, with a focus on youth and the long term unemployed, as well as dedicated skills upgrade programmes. The finalisation of the national qualifications framework should be the first step in a progressive reform of the education system, aimed at improving the outcomes of the system, thereby enhancing the human capital productivity.
7. Stimulate private investment, for example by establishing public schemes to support lending to SMEs and research activities in companies. To increase public investment, improve preparation and speed up the implementation of public projects. Step up the works on corridors VII and X in line with the regional core network. Improve energy production and transmission, most notably by better governance of energy firms, regulation of the network and the construction of gas inter-connectors.

Annex: Overall assessment of programme requirements

The government adopted the Economic Reform Programme on 12 March 2015 and formally submitted it to the European Commission on 13 March 2015.⁽¹⁾ The programme is in line with the medium-term fiscal strategy and the 2015 budget and covers the period 2015-2017. In line with the requirements to progressively adapt the economic and fiscal surveillance of the enlargement countries to the EU strengthened economic governance, the programme includes sections assessing the sustainability of the external position and the main structural obstacles to growth. However, the programme's structure does not fully follow the guidance provided by the Commission.

Macro framework

The programme presents a clear and concise picture of past developments. It also covers all relevant data at the time of drafting it. The macroeconomic framework presented in the ERP is sufficiently comprehensive and coherent. The macroeconomic scenario is plausible and in line with the suggested structural reform measures. Major uncertainties and risks are clearly outlined and recognised by the programme. The programme presents an alternative scenario, envisaging a deep recession in 2015 and a tepid recovery thereafter. It would gain clarity if it included more details on the performance of the various demand components and if the underlying assumptions were made more explicit. The ERP also includes an alternative fiscal scenario, based on the assumption that consolidation measures are not implemented. However, it would have benefitted if this scenario was directly derived from the alternative, more 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, although some of them are less specified and subject to higher uncertainty. The stated objective of stabilising government debt by the end of the programme would likely require additional efforts and further consolidation measures would be needed after 2017 in order to restore debt sustainability. 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. As Serbia has not started submitting fiscal notification data to Eurostat, significant efforts would be needed to ensure ESA '95 compatibility of fiscal data.

Structural reforms

The structural reform framework is sufficiently comprehensive. However, the programme fails to provide information on the budgetary implications of some of the presented major macroeconomic structural reforms and on the content of several measures, in particular those aimed at improving the business environment.

(¹) The authorities have submitted the programme to the European Commission informally on 6 February 2015.

5. TURKEY

5.1. OVERALL ASSESSMENT

Turkey's Economic Reform Programme (ERP) for 2015-2017 was received by the Commission on 13 March 2015, i.e. six weeks after the requested date. Due to the late submission, the present assessment is limited to the main features of the programme.

The Turkish economy has grown at a relatively moderate pace since the post-recessionary boom in 2010-11. In 2014, overall economic activity slowed sharply after a robust expansion in the first quarter, resulting in annual GDP growth of 2.9 %. The monetary policy tightening in January 2014 and some macro-prudential measures reined in consumer borrowing and spending. Tighter financial conditions resulted in a renewed contraction of business investment. Net exports, however, improved significantly and became the main contributor to GDP growth, benefiting from a temporarily more competitive exchange rate and sharply lower gold imports.

Some of the ERP's medium-term macro-economic projections appear rather optimistic. GDP growth is projected to strengthen to 5 % in the course of the programme period, i.e. clearly above the 3.1 % average growth rate over the past three years. With an estimated potential growth rate of around 4 %, the output gap is projected to close gradually over the coming years from a moderately negative position in 2014. Based on 2 – 2.5 % annual employment growth, the unemployment rate is projected to fall by half a percentage point over the programme period which seems optimistic in view of the strong trend growth of the labour force in recent years. The macro-economic projections are based on the oil price and exchange rates in the third quarter of 2014. If more recent market developments had been taken into account, the projections for the current account and for near-term inflation would have been more favourable. Inflation in 2016 and 2017 is projected in accordance with the official target rate of 5 %.

Turkey's economy continues to face two major macro-economic challenges. On the external side, the current account is in large and persistent deficit. It amounted to 5.7 % of GDP in 2014 and the ERP projects it to decline to 5.2 % of GDP by 2017, possibly more if energy prices stay at current levels. The external deficit makes the economy dependent on large and sustained capital inflows. As net foreign direct investment has declined significantly since the global financial crisis, most of the deficit is financed with relatively short term capital inflows which are more sensitive to changing expectations regarding international yield differentials and risk sentiments. This tends to result in large exchange rate swings accompanied by - sometimes painful - macro-economic adjustments. Gross external debt is trending higher, reaching EUR 331 billion (53.3 % of GDP) at the end of 2014. Net international reserves amounted to EUR 35.6 billion (5.8 % of GDP) which is relatively low, particularly considering Turkey's external financing and re-financing requirements. The current account deficit and the associated vulnerability can only be reduced by increasing national saving.

On the internal side, the economy is suffering from entrenched inflation. The consumer price index increased at an average annual rate of 8.4 % over the past ten years. In the first quarter of 2015, headline inflation still hovered in the 7-8 % range despite the oil price decline. High single-digit inflation rates are problematic in terms of macro-economic stability, resource allocation and re-distributive effects. A sustained lowering of inflation will require that price stability becomes the clear focus of monetary policy, with other policy objectives being pursued with separate instruments.

Table II.5.1:

Comparison of macroeconomic developments and forecasts										
	2013		2014		2015		2016		2017	
	COM	ERP	COM	ERP	COM	ERP	COM	ERP	COM	ERP
Real GDP (% change)	4.1	4.1	2.8	3.3	3.7	4.0	4.0	5.0	n.a.	5.0
<i>Contributions:</i>										
- Final domestic demand	5.2	5.1	1.2	1.0	3.2	3.9	4.2	5.2	n.a.	5.3
- Change in inventories	1.4	1.6	-0.1	0.2	0.4	0.1	0.1	0.1	n.a.	-0.2
- External balance of goods and services	-2.5	-2.6	1.6	2.0	0.0	0.0	-0.3	-0.2	n.a.	-0.1
Employment (% change)	2.8	2.8	5.1	5.0	3.2	2.0	3.6	2.5	n.a.	2.2
Unemployment rate (%)	8.9	9.0	9.8	9.6	10.5	9.5	10.5	9.2	n.a.	9.1
GDP deflator (% change)	6.1	6.1	7.5	9.1	9.0	6.0	5.4	5.3	n.a.	5.0
CPI inflation (%)	7.5	7.5	8.9	8.9	6.3	7.2	5.8	5.5	n.a.	5.0
Current account balance (% of GDP)	-7.9	-7.9	-6.0	-5.7	-3.6	-5.4	-4.2	-5.4	n.a.	-5.2
General government balance* (% of GDP)	-1.6	-1.6	-1.5	-1.4	-1.4	-1.1	-1.3	-0.6	n.a.	-0.1
Government gross debt (% of GDP)	36.2	36.2	34.3	33.1	32.2	31.8	31.2	30.0	n.a.	28.5

* excluding privatisation revenues
Sources: Economic Reform Program 2015 (ERP), Commission Winter 2015 forecast (COM)

According to the ERP, the fiscal deficit of general government (excl. privatisation revenues) has fallen from 1.6 % of GDP in 2013 to 1.4 % in 2014, although total expenditures have increased more than planned. The programme projects the deficit to narrow gradually to 0.1 % of GDP by 2017 driven by a 2.6 percentage point fall in the ratio of total expenditures to GDP. It remains unclear which policy measures would support such spending restraint. The structural deficit of general government has fallen from 2.3 % of GDP in 2013 to 1.9 % of GDP in 2014 and is projected to decline further to 0.4 % of GDP by 2017.⁽¹⁾ Helped by high nominal GDP growth, the debt-to-GDP ratio of general government has trended downwards over the past five years to 33.5 % of GDP at the end of 2014. The ERP projects the debt ratio to decline further to 28.5 % by the end of 2017. 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.

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, but remains overly complex. There is ample room for improving the transparency and predictability of monetary policy. The easing of monetary policy since the second quarter of 2014 is inconsistent with the 5 %-inflation target.

Regarding structural reforms, the ERP describes briefly the 25 "Priority Transformation Programs" which have been prepared to ensure the realisation of Turkey's Tenth Development Plan enacted in 2014 and covering the period 2014-2018. Action plans have been prepared with a total of more than 1,200 measures to ensure the effective implementation of the "Priority Transformation Programs", although no details are provided in the ERP. Generally, the transformation programmes would increase the state's role in the economy, particularly through actively encouraging import substitution and a more active use of public procurement. Their focus is, among other things, on creating local manufacturing capacity through subsidising investments and discouraging imports.

The ERP provides little detail about the very important issue of improving the investment climate which 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. The transformation programme entitled "Business and Investment

(1) The ERP's calculation of the structural deficit in 2014 is based on an output gap of -1.1 % and uses a concept of general government according to which the actual deficit was 2.0 % of GDP because all one-off revenues and expenditures are excluded. The IMF's Article IV Staff Report from December 2014 estimates that the structural deficit of general government was close to 3 % of GDP in 2014 based on a roughly closed output gap.

Climate Improvement Program" aims very ambitiously to increase the share of private sector investments in GDP from an estimated 15.5 % in 2014 to 19.3 % in 2018. This would require a massive acceleration of private investments over the next four years from an annual growth rate of 0.5 % in both 2013 and 2014. Yet, the ERP provides no details about the measures which will instigate this transformation. In the Commission's assessment, a more favourable investment climate depends on strengthening the rule of law, the separation of powers, and political pluralism. Both domestic and foreign investors need to be reassured that property rights are protected against arbitrary or disproportionate state action.

Apart from referring to the Tenth Development Plan, the ERP describes recent and ongoing policy measures regarding product markets, the financial sector, the labour market, public finance reform, and other reform areas. 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.

5.2. THE 2015 POLICY GUIDANCE

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] Participants hereby invite Turkey:

1. to promote domestic saving in view of the persistently large current account deficit. Fiscal policy has an important role to play in this regard by following a sufficiently restrictive stance. Reducing the rigidity of public expenditures would help to make the fiscal policy stance more responsive to macroeconomic needs. The adoption of a fiscal rule would enhance budget transparency, provide an important fiscal anchor and enhance credibility.
2. to continue to take consistent steps to reinforce the focus of monetary policy on the pursuit of price stability, with other policy objectives being pursued with separate measures, and thereby contribute to improving both the functioning and the credibility of the inflation targeting regime.
3. to make sustained efforts to improve the business environment and Turkey's attractiveness as an investment destination, not least for foreign direct investments, in view of the continuing dependence on large capital inflows. This requires wide-ranging reforms, including strengthening the rule of law, making it easier to start businesses, and strengthening competition through continued liberalisation of product and service markets.
4. to accelerate the implementation of a comprehensive structural reform programme. Overall, this is essential to improve the functioning of the markets for goods, services and labour which, in turn, would increase potential growth and international competitiveness on a sustainable basis. In particular, Turkey should upgrade and make better use of its human capital through the pursuit of the education agenda and the deepening and widening of labour market reforms. Specifically, the qualifications of low-skilled workers should be improved through training and female labour force participation should be stimulated through flexible working conditions.

Annex: Assessment in terms of programme requirements

The ERP is in line with the government's Medium Term Programme for 2015-2017 and with the Tenth Development Plan for 2014-2018. Like the Pre-Accession Economic Programmes submitted in previous years, the ERP 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. Most significantly, the ERP fails to report on the implementation of the policy guidance provided in the Conclusions of the Ministerial Dialogue between the Economic and Finance Ministers of the EU and the Candidate Countries on 6 May 2014.

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 macro framework is drawn from the Medium Term Programme for 2015-2017 which was prepared in mid-2014 and released in October 2014. More recent market and policy developments have not been taken into account in the projections although the effects of the recent oil price decline are discussed in a text box.

Fiscal framework

Efforts are required to improve fiscal data at general government level on a unified accounting basis according to ESA/international standards. It remains difficult to assess Turkey's public finance situation properly in the absence of regular and consolidated general government budget reports. There is little information about the measures underlying the fiscal projections for the programme period, making it difficult to assess their soundness. 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's forward-looking part is a short presentation of the 25 transformation programmes which have been defined under the umbrella of Turkey's Tenth Development Plan in 2014. The ERP fails to present the transformation programmes within a strategic framework for economic development over the medium term. The remaining information is mainly backward-looking and concerns product markets, the financial sector, the labour market, public finance reform, and other reform areas.

6. BOSNIA AND HERZEGOVINA

6.1. EXECUTIVE SUMMARY

Despite the heavy spring floods and the slowdown throughout the year, the economy of Bosnia and Herzegovina is envisaged to post a modest economic growth in 2014. In a rather optimistic scenario, GDP growth is programmed to increase threefold to 3.4% in 2015 and remain broadly on the same level in the outer two years of the programme period relying heavily on the recovery of domestic demand. At the same time and somewhat contradictory to it, is the substantial deceleration of the pace of imports which would support the re-emerging of net exports-driven economic growth. However, the economic recovery remains fragile and risks are clearly tilted to the downside. In particular, the programme's projections for investment growth appear upbeat and would certainly require immediate decisive steps to improve business environment as well as a speed-up of reconstruction activities following the spring floods. In addition, the ongoing governments' formations and the difficult political situation could adversely affect the timely implementation of much-needed, growth-supporting structural reforms.

External imbalances, which started to widen in 2014, are projected to narrow again on the back of growing exports coupled with lower import growth which seems to be in contradiction with a quite upbeat recovery of domestic demand. Thus, current account development could turn out to be less benign than projected and the financing of external imbalances is likely to rely primarily on FDI flows, which have proved to be unstable in the past. The acceleration of net FDI inflows, as projected in the ERP, would require significant improvements in the business environment. So far, FDI inflows have primarily channelled into some energy and other infrastructure projects and as such have provided little support to diversifying the narrow production base and raising productivity on a broader front. Against this background, considerable risks to external sustainability remain a matter of concern.

Budget imbalances deteriorated somewhat in 2014 with the budget deficit edging up to 1.8% of GDP and the fiscal policy needs still to be anchored in a credible medium-term framework. The budget deficit is forecast to fall from 1.7% in 2015 to 0.6% of GDP in 2017. Over the programme period, the authorities intend to embark on a fiscal strategy based on expenditure consolidation of 6.5 percentage points of GDP, which seems to be overly ambitious given that fiscal consolidation should be pursued in a growth-friendly way. The proposed consolidation measures are back-loaded and broad-based with both capital and current spending generally declining as a percentage of GDP. However, these adjustments would need to be supported by the design and bold implementation of structural 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 the optimistic macroeconomic scenario.

Despite a few planned measures to improve the targeting of social transfers –currently accounting for over 16% of GDP- the programme does not provide a convincing and fully-elaborated strategy to shift spending towards a more growth-enhancing pattern. Consolidated government expenditures continue to be increasingly dominated by current spending with capital outlays declining to levels below 3% of GDP over the programme horizon. Moreover, the public sector wage bill is set to remain broadly unchanged at about 11% of GDP in 2015 which is in contrast to the envisaged public administration reform.

The programme recognises the major structural obstacles to growth, in particular related to the improvement of the business environment, which remains one of the most challenging in the region. The softening of the high business barriers is being addressed by simplifying business registration procedures and by plans to reduce para-fiscal charges in some sectors as well as by enhancing company's liquidity in the Federation. In Republika Srpska steps are planned to be taken towards increasing the transparency of

existing para-fiscal charges as well as simplifying the procedure of issuance of construction permits. However, there is ample room for improvement in terms of supporting the reform intentions with specific measures and presenting a timeframe for their implementation along with addressing key challenges such as the enforcement of contracts and improving access to financing.

The dysfunctional labour market and the low quality of human capital remain key concerns in Bosnia and Herzegovina. The modest growth of the economy of Bosnia and Herzegovina in 2014 failed to unwind the labour market, especially for low-skilled workers and youth employment and a further negative impact following the spring floods could be expected. The ERP generally recognises the significant economic challenges; however the policy response remains fragmented. To this end, the authorities in Republika Srpska envisage steps towards a reduction of the tax wedge of employers, while otherwise the programme focuses mainly on a few active labour market policies. Overall, the programme remains silent on other pressing reform areas such as the introduction of more flexibility in the employment process and contract bargaining.

6.2. ECONOMIC OUTLOOK AND RISKS

The ERP projects a substantial acceleration of the pace of recovery supported increasingly by domestic demand. The ERP foresees a real GDP growth to more than triple to 3.4% in 2015 as compared to 2014, and to slightly accelerate to 4% and 4.4% in the outer two years. In contrast to 2014, external sources are seen to become again an engine of growth as from 2015 in line with a gradual acceleration of domestic demand. In particular, a robust increase in investments (10% annual average over 2015-2017), along with a steady exports expansion (5.8%) would be the main drivers of growth. Private consumption growth is projected to accelerate at a much more moderate pace, reflecting high levels of unemployment and limited scope for a strong pick-up in disposable incomes. The growth of government consumption remains muted due to fiscal consolidation needs. The contribution from the external side is expected to return to positive territory in 2015, and increasingly so in the outer years of the programme period, in view of accelerating export growth. It will remain well above the projected growth of imports, the latter appearing rather low given the robust pace of private consumption. Thus, the contribution of net exports to growth could turn out lower than projected. On the production side, in the aftermath of the spring floods in 2014, the programme projects all economic branches to gradually recover, with the biggest growth contribution coming from services and the extracting industry, which in itself implies limited prospects for a productivity-enhancing shift of resources going forward.

The macroeconomic scenario appears rather optimistic; however, risks are broadly recognised by the programme and are tilted to the downside. The pick-up in economic activity started in 2013 came abruptly to a halt in the second quarter of 2014 due to the heavy spring floods, before signs of a feeble recovery re-emerged towards the end of the year. The ERP's projections for solid investment growth appear somewhat optimistic in view of the slow progress of reconstruction activities and the meagre investment activity in the private sector, while at the same time hardly any indications for a change of policy to increase investor appetite at this juncture are discussed. The alternative scenarios acknowledge mainly downside risks stemming from a renewed deterioration in the economic environment in the EU, which could weaken exports and capital inflows. Potential risks related to domestic factors seem to have been largely neglected. Indeed, the enduring government formations and the difficult political situation could adversely affect the timely implementation of much needed, growth-supporting structural reforms. A strong policy commitment seems essential to support an urgently-needed improvement in business environment, which still remains one of the most challenging in the region. A re-launch of the privatisation process, especially in the Federation, would be a way to support private sector development and to broaden the sources of real growth.

Table II.6.1:

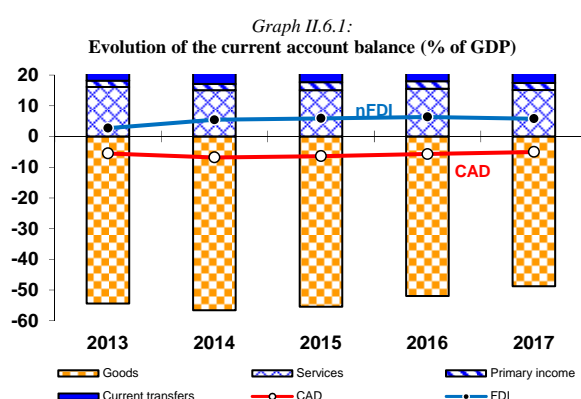
Macroeconomic developments and forecasts

	2013	2014	2015	2016	2017
Real GDP (% change)	0.7	1.1	3.4	4.0	4.4
<i>Contributions:</i>					
- Final domestic demand	-0.2	3.1	3.0	4.1	4.3
- Change in inventories	-0.3	0.2	0.2	-0.5	-0.3
- External balance of goods and services	1.2	-2.3	0.2	0.3	0.4
Employment (% change)	1.0	-1.2	1.3	1.6	2.1
Unemployment rate (%) LFS	27.5	27.5	27.0	26.4	25.6
GDP deflator (% change)	1.9	1.4	1.0	1.4	2.0
CPI inflation (%)	-0.1	-0.7	1.0	0.9	1.2
Current account balance (% of GDP)	-5.5	-6.8	-6.4	-5.7	-5.0

Sources: National Economic Reform Programme (NERP) 2015

The current account deficit is expected to gradually narrow despite envisaged buoyant investment activity. Following a significant narrowing of the current account deficit in 2013 to slightly below 6% of GDP; the acceleration in import activity in 2014 highlighted the temporary nature of this improvement implying that external vulnerabilities are likely to persist. The ERP projects total exports to expand by around 7.7% on average in 2015-17, largely backed by a recovery in the EU, which accounts for 60% of total exports. Slower growth in the EU or renewed financial distress could significantly weaken exports, as acknowledged by the programme. In addition, as recovery in domestic demand gathers pace, total imports are likely to accelerate at a stronger pace than projected, given the high import intensity of investment and production. On a positive note, international reserves which are on an increasing trend and cover around 5.9 months of imports of goods and services, provide an adequate safeguard against adverse shocks. The outlook for a decreasing current account deficit, reaching again 5% of GDP by 2017, appears overly optimistic in the context of limited product diversification, a narrow export base and still low productivity levels.

The financing of the current account deficit continues to be dependent on rather unstable FDI flows. Net FDI, which is characterised by a low sectoral diversification, has been on a declining path in recent years edging down from 7% of GDP on average in the run-up to the crisis to around 3% of GDP in 2014. The programme somewhat optimistically envisages an acceleration of FDI inflows to around 5.7% of GDP in 2017, which would then fully cover the programmed current account deficit. Moreover, FDI inflows are primarily channelled into some energy and other infrastructure projects and as such provide little support to diversifying the narrow production base and raising productivity on a broader front.



Source: National Economic Reform Programme (NERP) 2015, ECFIN calculations

Sustained improvement of the labour market is pending. Although Labour Force Survey data indicated no significant change on the labour market in 2014 – the unemployment rate staying at 27.5% – the actual situation is less clear. Registered unemployment rate slightly edged down to 43.6% in 2014, while employment remained broadly unchanged. Nevertheless, the slow reconstruction of damaged

industries due to the spring floods in 2014 may put a lasting drag on the recovery on the labour market. While the macroeconomic scenario hardly recognises the structural downside risks, it foresees employment levels to rise by 1.6% and 2.1%, respectively in the outer years of the programme period heavily depending on the pace of the strengthening of the investment activity and the external demand. This might, however, appear somewhat optimistic as any gains in private sector employment might be largely offset by job losses also due to public sector restructuring in the context of an envisaged public sector reform.

The banking system remains to be burdened with high level of NPLs. The banking sector is still well capitalized with regulatory capital adequacy ratio declining slightly to 16.3% but well-above the regulatory minimum of 12%. The profitability returned to positive territory in 2014 and the liquidity of the system remains on comfortable levels as precautionary motives have allegedly led to an acceleration of the pace of increase of total deposits to 8.4% in 2014 allegedly pushed as well by precautionary motives. Nevertheless, the credit risk indicators of the banking system raise some concerns as the quality of loan portfolio as measured by the share of non-performing loans in total loans remains elevated at 14% in the fourth quarter of 2014 with a further increase possible to result from the spring floods. At the same time, the provisioning has not increased in conformity with rising credit risks as the ratio of provisions to non-performing assets stayed broadly unchanged at 66%. However, despite some recent progress, legislative changes to pave the way for loan restructurings are still missing and further efforts remain necessary to encourage the clean-up of banks' balance sheets.

Credit growth remains muted despite enhanced liquidity in the banking sector. In spite of the volatility of economic growth throughout 2014, annual loan growth edged up by 3.8%, mirroring somewhat extended lending to the household sector, which was partly balanced off by a stagnating lending to the private non-financial corporate sector. Accordingly, the dependence on foreign financing has gradually declined with the loan-to-deposit ratio adjusting downwards from over 122% in 2008 to currently 109%, thus reflecting the increasing importance of domestic sources of funding. However, the continuous deterioration of the credit portfolio weighs on the sustained resumption of lending growth and on economic recovery thus stressing the importance of an establishment of a NPL resolution framework. The ERP's scenario projecting the credit growth in 2015-2017 to remain broadly on the same level as in 2014 appears realistic given the slow progress of regulatory and legislative changes for loan restructuring and for the clean-up of banks' balance sheets.

Table II.6.2:

Financial sector indicators

	2010	2011	2012	2013	2014
Total assets of the banking system, mEUR	10,828	11,196	11,414	11,988	12,515
Credit growth	-0.9	5.6	5.2	2.5	3.8
Bank loans to the private sector	52.2	51.5	48.6	47.6	46.6
Deposit growth	4.7	2.6	2.6	5.1	8.4
Loan to deposit ratio	1.16	1.18	1.20	1.15	1.09
Financial soundness indicators					
- non-performing loans	9.1	12.0	12.7	14.5	14
- net capital to risk weighted assets	16.2	17.1	17.0	17.8	16.3
- liquid to total assets	29.0	27.2	25.4	26.4	26.8
- return on equity	-5.5	5.8	4.9	-1.4	6.0
- forex loans to total loans	70.1	66.9	63.1	62.9	62.4

Sources: National Central Bank, DataInsight

6.3. PUBLIC FINANCE

Fiscal imbalances are on the rise prompting the rebalancing of budgets in 2014. The heavy spring floods and the non-disbursement of tranches under the IMF Standby Arrangement caused revisions of the budgets of the two entities and the Institutions of Bosnia and Herzegovina with a view to providing emergency financing for the flooded areas. The ERP estimates that the fiscal deficit in 2014 amounted to 1.8% of GDP, slightly above the target in the Global Framework for Fiscal Balance and Policies 2015-2017 (1.1% of GDP). Public expenditures in 2014 remained broadly unchanged at 42.1% of GDP and were heavily biased towards current expenditures. The slight improvement of expenditure composition which started in 2013 seems to have been partly offset by pressures on current spending, resulting, inter alia, from wage increases for civil servants in April 2014 in Republika Srpska. On the revenue side, the enduring problem of VAT refunds as well as the pending collection of old VAT debt continue to pose a substantial drag despite measures adopted to improve the collection of VAT revenues and the increase of excise duties on beer and tobacco as of the third quarter in 2014. Thus, consolidated fiscal revenues are projected to have remained broadly unchanged from the previous year at 40.2% of GDP. However, the programme lacks an estimate of the budgetary effects of one-off solidarity measures introduced i.e. temporary wage and pension reduction in Republika Srpska due to the heavy spring floods as well as of the planned tax broadening measures in the Federation.

The 2015 budgets do not shift towards a more growth-enhancing pattern of spending. While the 2015 Budget of Republika Srpska has been adopted in December 2014, the 2015 budgets of the Federation of Bosnia and Herzegovina and the Institutions of Bosnia and Herzegovina failed to be adopted on time, prompting decisions on temporary budget financing for the first quarter of 2015. In contrast to the previous year, the envisaged fiscal measures of the programme for 2015 and beyond focus mainly on the expenditure side, more so in Republika Srpska. Thereby, 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. Total expenditure-to-GDP ratio is expected to somewhat decline to 40.6% of GDP. Nevertheless, the envisaged measures remain broadly vague foreseeing reductions mainly in social transfers in the Federation along with a decline of transfers to the Health and Solidarity Funds in the Republika Srpska. Capital expenditures are set to fall to 3.7% of GDP in 2015, which goes clearly against the objective of a more growth-enhancing structure of spending. On the revenue side, the significant decline of revenues as a percentage of GDP to 38.9% of GDP, although still less than on the spending side is planned to be due to unfavourable developments in all categories, which appears inconsistent with the optimistic macroeconomic scenario. Only a few measures such as the envisaged reduction of the employer's tax wedge in Republika Srpska underpin that strategy. At the same time, the planned broadening of the revenue base as well as foreseen improvements in tax collection measures for tax base broadening in the Federation would in itself contrast with a lower revenue ratio.

Over the medium term, the objective is for a back loaded consolidation of public finances. The ERP foresees to bring expenditures to 35.6% of GDP in 2017, edging down by 6.5 percentage points of GDP (compared to 2014), which seems to be overly ambitious. The reduction of budget deficit is foreseen to be back-loaded with an improvement of general government balance by 1.2 percentage point of GDP- from 1.8% of GDP in 2014 to 0.6% of GDP in 2017. Overall, the medium-term strategy for the 2016-2017 lacks a description of the underlying fiscal and structural reform measures to support the spending and deficit reductions. The intended freeze of public sector payroll explains part of the reduction of the spending-to-GDP ratio. Otherwise, the programme refers to some measures to increase expenditure efficiency, i.e. set-up of a registry for subsidies on all governance levels in Republika Srpska or an inspection of current transfers in the Federation. On the revenue side, the projected dynamics foresees that total-revenue-to-GDP ratio to decline substantially with an annual adjustment of 1.7 percentage points of GDP on average over 2015-17 to reach 35% of GDP due to unfavourable developments in all revenue categories. The conservative projection of revenues is somewhat in contradiction with the macroeconomic scenario and the intended measures for tax broadening and enhanced tax collection.

Table II.6.3:
Composition of the budgetary adjustment (% of GDP)

	2013	2014	2015	2016	2017	Change: 2014-17
Revenues	40.8	40.2	38.9	36.5	35.0	-5.2
- Taxes and social security contributions	35.3	34.7	33.6	31.9	30.6	-4.1
- Other (residual)	5.5	5.5	5.3	4.6	4.4	-1.1
Expenditure	42.3	42.1	40.6	38.1	35.6	-6.5
- Primary expenditure	41.7	41.3	39.7	37.2	34.8	-6.5
<i>of which:</i>						
Gross fixed capital formation	3.8	4.0	3.7	3.3	2.9	-1.1
Consumption	18.9	18.5	17.9	17.0	16.0	-2.5
Transfers & subsidies	17.2	17.1	16.6	15.5	14.5	-2.6
Other (residual)	1.8	1.7	1.5	1.4	1.4	-0.3
- Interest payments	0.6	0.8	0.9	0.9	0.8	0.0
Budget balance	-1.5	-1.8	-1.7	-1.6	-0.6	1.2
- Cyclically adjusted	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Primary balance	-0.9	-1.0	-0.8	-0.7	0.2	1.2
Gross debt level	33.9	36.9	35.0	32.1	27.8	-9.1

Sources: National Economic Reform Programme (NERP) 2015, ECFIN calculations

The ambitious fiscal strategy faces non-negligible fiscal risks and lacks a comprehensive description of the medium-term measures beyond 2015. The programme recognises the need to perform measures to change the unfavourable expenditure structure. In line with this, the public sector compensation for employees is to decrease by almost 1.1 percentage point compared with 2015, to 10.1% of GDP, as the public sector payroll will be kept largely unchanged partly due to an envisaged broad-based public sector reform in Republika Srpska. The social transfers are to undergo a revision to improve their targeting, which is planned to reduce their share from the current 16% to about 13.6% of GDP in 2017. At the same time, however, capital expenditures are projected to decline over the program horizon. In addition, in contrast to the previous year, the programme remains silent on other areas with pressing reform needs as the pension reform and the public administration reform in the Federation as well as the health sector reform in both entities.

Box : The budget for 2015

Due to the enduring government formations following the general elections in October 2014, only the parliament of Republika Srpska managed to adopt its budget in December 2014 before the expiration of the last year's budget year. In contrast, the 2015 budgets of the Federation of Bosnia and Herzegovina and the Institutions of Bosnia and Herzegovina failed to be adopted on time, prompting decisions on temporary budget financing for the first quarter of 2015.

The envisaged consolidation measures for 2015 and beyond are focusing primarily on the expenditure side, in particular including measures to increase expenditure efficiency, while some of the measures on the revenue side intend to broaden the revenue base, especially in the Federation.

Table: Main measures in the budgets for 2015

Revenue measures	Expenditure measures
Law on Games of Chance in the Federation (0.17% of GDP)	Reduction of social protection transfers in Republika Srpska (0.03% of GDP)
Law on the amount of the default interest rate on public revenue in the Federation (0.05% of GDP)	Reduction of outlays for non-financial assets in Republika Srpska (0.2% of GDP)
Collection of tax arrears in Republika Srpska (0.02% of GDP)	Reduction of transfers to the Health Insurance Fund in Republika Srpska (0.02% of GDP)
	Reduction of transfers to the Solidarity Fund for Rehabilitation of Republika Srpska (0.04% of GDP)
	Transfers between budget units of the same government levels (0.06% of GDP)
Total revenues effect 0.2% of GDP	Total expenditure effect 0.3% of GDP

Source: Economic Reform Programme 2015

The structure of the public debt poses an increasing concern. In the programme, Bosnia and Herzegovina's public debt is overly-optimistically projected to edge down to 31.7% of GDP in 2017 from estimated 40.5% of GDP in 2014. In line with the revised budgets in 2014, domestic debt increased from 10% to 11.5% of GDP mainly due to the issuance of short-term government securities substituting for the non-disbursement of tranches under the IMF Standby arrangement. In the programme period, domestic public debt is projected to progressively decline to 6.7% of GDP on the back of a steady decrease of verified old currency savings and war claims. In contrast, foreign public debt is projected to slightly edge down to 25.7% of GDP in 2017, which stays somewhat at odds given the elevated financing needs for reconstruction following the heavy spring floods in 2014. The currency structure of the total public debt could be considered relatively favourable given the country's currency board arrangement, as nearly 33% 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 staying at 1.45% with some 51.2% of total debt under a fixed interest rate. Nevertheless, the maturity structure worsened somewhat with the average repayment period of the existing loan commitments estimated at 8 years.

Roll-over and re-financing risks of public debt are elevated. Public debt servicing, which soared over twofold in recent years and reached over 5% of GDP in 2014, is projected to surge further in the programme period to reach 5.6% of GDP in 2017, thus posing some risks for its refinancing. Furthermore, the budget support through the extension of the Stand-By Agreement with the IMF until mid-2015 although still formally on track has not been disbursed since June 2014 due to delays of implementation of already committed reforms. Moreover, the already elevated refinancing needs following the multiple issuance of government securities in 2014 and the limited availability and a partly

standstill of other sources of financing would pose an additional risk to the fiscal projections given the tight fiscal space and as country has no access to international capital markets.

Table II.6.4:

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

	2013	2014	2015	2016	2017
Gross debt ratio [1]	37.2	40.5	38.9	36.0	31.7
Change in the ratio	-0.4	3.3	-1.6	-2.9	-4.3
<i>Contributions [2]:</i>					
1. Primary balance	-0.8	-1.0	-0.8	-0.7	0.2
2. “Snow-ball” effect	-1.0	-0.1	-0.8	-1.1	-1.3
<i>Of which:</i>					
Interest expenditure	0.6	0.8	0.9	0.9	0.8
Growth effect	-0.9	-0.4	-1.3	-1.5	-1.5
Inflation effect	-0.7	-0.5	-0.4	-0.5	-0.7
3. Stock-flow adjustment	-0.2	2.4	-1.6	-2.5	-3.1

Notes:

[1] End of period.

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

Source: Economic Reform Programme (ERP) 2015, ECFIN calculations

6.4. STRUCTURAL REFORMS

The programme's response to well identified structural obstacles to growth leaves ample room for improvement. The programme rightly recognises the main impediments for growth, but the strategies proposed are vaguely defined. 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, especially in the Federation. In addition, besides the size of the informal economy remaining a key challenge, it is imperative to enhance the functioning of the labour market to combat the persistently high unemployment. Generally, reform measures proposed in the programme remain piecemeal at best and thus fail to provide a comprehensive and convincing response to the economic challenges the country is facing.

Reforms in the business environment need to be urgently accelerated. While the programme recognises weaknesses in the business environment, it hardly addresses them in a comprehensive manner. The ERP discusses the adoption of a set of amendments of relevant laws aiming to increase the liquidity as well as to ease market entry regulations for businesses through the Law on Companies in the Federation, nevertheless fails to deliver a respective timeline for their implementation. In addition, measures to increase the transparency of existing para-fiscal charges as well as to simplify the procedure of issuance of construction permits and to reduce the tax burden on labour to combat the large informal economy are planned to be implemented in Republika Srpska. However, there is still ample room for further measures to improve the business environment notably by simplifying the regulatory environment through the mutual recognition of business registration, improving contract enforcement and addressing the issue of property rights and attracting FDI.

Necessary reforms of the labour legislation to decrease labour market rigidities are still pending.

Although labour market conditions improved somewhat during 2014, the structural nature of unemployment is reflected by the high share of long-term unemployment accounting for around four fifths of total jobseekers along with a share of youth unemployment staying close to 60%. A significant difference between the registered and survey-based labour figures points towards the existence of a fairly large informal labour market. Moreover, the very low activity rate of around 43% suggests there is an inactivity trap caused also by poorly targeted social benefits. The ERP generally points at these bottlenecks. However, outlined reforms are limited to plans in Republika Srpska to reduce the tax burden for employers to combat informal employment in addition to plans for a public administration reform in Republika Srpska with a view to enhancing the flexibility of the labour market.

Hardly any progress of the privatization agenda is foreseen. In spite of the potential efficiency gains and relieve of the burden for public finances, the privatisation agenda still remains an unfinished task, especially in the Federation. The programme does state it as a priority in Republika Srpska, due to the 2/3 of the state capital already denationalised. In contrast, the privatisation strategy for 2015 in the Federation foresees the sale of 14 state enterprises; most of them -with majority state ownership. It, nevertheless, fails to deliver a strategy to address the lack of investors' interest, thus, additionally aggravating the backtracking of the privatization agenda. Overall, given the broad stalemate of privatisation deals in the recent years and the absence of privatisation plans beyond 2015 in the ERP, decisive steps would need to be taken to advance corporate restructuring.

Steady progress in reform measures to safeguard financial stability and strengthen the regulatory framework. With a view to tackle mounting credit risks due to the heavy spring floods, a framework for emergency loan rescheduling was adopted in June 2014. In addition, the regulatory framework has been strengthened by a 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. However, against the background of elevated NPLs amounting to 14% as of December 2014 and expected to increase even further due to the spring floods, it is crucial to fully develop and implement a financial restructuring programme to address the high burden of non-performing loans on bank balance sheets from both a stock and a flow perspective.

6.5. IMPLEMENTATION OF THE 2014 POLICY GUIDANCE

In line with the targeted policy guidance by the Commission as outlined in the letter from 30 June 2014 by the Commission's Vice President Olli Rehn, the authorities of Bosnia and Herzegovina have taken only limited steps to implement recommended reforms. The 2015 budget has only been timely adopted in Republika Srpska, while the Institutions of Bosnia and Herzegovina and the Federation adopted a decision on temporary financing in the first quarter of 2015 due to the still ongoing governments' formation. In addition, the strengthening of fiscal discipline, especially in the Federation, has been featured by strong implementation gaps. On a positive note, however, some efforts have been made to improve the business environment. Although still needed to be implemented, there are few legislative changes adopted in Republika Srpska aiming to simplify and shorten the process of dealing with construction permits and to reduce the labour tax wedge of employers. In addition, legal amendments in Republika Srpska have been prepared to reduce the labour tax wedge of employers and thus combat informal economy. At the same time, the Federation reduced somewhat the costs of business registration and prepares a legal act envisaging a reduction of the minimum capital required. However, there has been hardly any progress on other pressing reforms such as the Pension reform and the restructuring of state-owned companies in the Federation or the reduction of para-fiscal fees in both entities. In addition, the share of NPLs remains elevated which underscores the need for further efforts to clean bank balance sheets.

Box: Implementation of the 2014 Policy Guidance

The following is a short assessment of the main measures taken or planned to be taken by Bosnia and Herzegovina in response to the policy guidance provided in Commission Vice-President Rehn's letter of 30 June 2014. The guidance was based on the Commission's assessment of Bosnia and Herzegovina's previous medium-term programme for 2014-2016, submitted in January 2014.

1. *Pursue the envisaged medium-term consolidation path of public finances, notwithstanding the impact of the floods and elevated financing needs on the 2014 budgetary position; undertake all efforts to ensure a timely adoption of the 2015 budgets; take steps to address obstacles to an efficient implementation of the Law on Budgets in the Federation, notably with a view to improving expenditure controls, fiscal discipline, budget reporting methods and the efficiency of tax authorities of lower levels of government.*
 - The 2015 budgets of the Federation of Bosnia and Herzegovina and the Institutions of Bosnia and Herzegovina failed to be adopted on time, prompting decisions on temporary budget financing for the first quarter of 2015. At the same time, the 2015 budget of Republika Srpska was adopted in December keeping 2015 expenditures broadly on the same level as in the 2014 revised budget.
 - To enhance fiscal discipline and coordination also with lower levels of government, the Law on Budgets in the Federation entered into force in January 2014, however, it has been characterised by a lack of efficient implementation so far. In Republika Srpska, a Draft Law on Fiscal responsibility, including an establishment of an independent Fiscal Council and a fiscal rule, has been prepared.
 - A Strategic Plan for the Tax Administration for 2014-2018, including income tax, profit tax and value added tax, has been adopted in the Federation with the aim to strengthen the tax administration and to improve the collection of taxes.
2. *Improve the composition of public spending and the sustainability of public finances by containing the public sector wage bill, taking steps towards a more rational allocation of staff in the civil service as well as an improved targeting of social expenditures through extensive audits, regular cost-benefit evaluations, the adoption of the necessary legislative changes and the implementation of the pension reform in the Federation.*
 - A public sector reform plan for 2014-2018 has been prepared by the government in Republika Srpska in January 2015, which envisages reforms of the public administration, public sector companies, health sector and education reforms, however, without specifying the budget impact and the time frame for implementation.
 - No significant progress has been made in the implementation of the Pension reform strategy in the Federation.
3. *Develop and implement a financial restructuring programme to address the high burden of non-performing loans on bank balance sheets from both a stock and a flow perspective.*
 - To safeguard the stability of the banking system, special measures to simplify and enhance the restructuring and rescheduling of loans of bank clients affected by the spring floods in May 2014 have been adopted. In addition, a one-year moratorium of loan repayments and rescheduling in the Federation as from June 2014 has been passed.
 - In October 2014 provisional measures for treatment of liabilities under leasing contracts affected by

the spring floods were adopted in the Federation.

4. *Improve the business environment notably by simplifying the regulatory environment through the mutual recognition of business registration and the facilitation of construction permits. Reduce costs as regards business entry and exit and the issuance of construction permits; take steps towards the reduction of para-fiscal fees without endangering the sustainability of public finances; improve the efficiency of companies with state ownership.*
 - Law on Business Registration has been adopted in the Federation with the aim to reducing somewhat business registration costs and time. In addition, a Draft Law on Companies is prepared, which envisages a reduction of the minimum capital required to register a company to 1000 KM, from previously 2000 KM.
 - A set of by-laws to the Law on spatial planning has been prepared in Republika Srpska to simplify the procedure of issuance of construction permits including a reduction of the costs and the time needed.
5. *Reduce labour market rigidities by introducing more flexibility in the process of collective wage bargaining and by addressing disincentives to hiring, including taking steps towards a reduction of the tax wedge while ensuring budget neutrality.*
 - In Republika Srpska, steps were taken to decrease tax wedge and address the disincentives to hiring by adopting amendments of the Law on contributions to reduce the labour tax wedge of employers from 33% to 31.6%, however without mentioning concrete steps to be taken to achieve budget neutrality.

6.6. THE 2015 POLICY GUIDANCE

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning Part I of the Economic Reform Programme Participants hereby invite Bosnia and Herzegovina to:

1. Improve the budget management framework by adopting and implementing the Law on Fiscal Responsibility in Republika Srpska, especially including the establishment of a Fiscal council and the adoption of a fiscal rule. Take steps to address obstacles to an efficient implementation of the Law on Budgets in the Federation, in particular the functioning of the Fiscal coordination body. Continue with the improvement of expenditure controls, fiscal discipline, budget reporting methods and the efficiency of tax authorities of lower levels of government.
2. Improve the composition of public spending to increase the fiscal space for capital investments by containing current expenditures through curbing the public sector wage bill and more efficiently allocating staff in the civil service at all levels of government. Take steps to better target social expenditures through extensive audits and finalisation of the establishment of the Single Registry of Beneficiaries of Cash Payments without Contribution in the Federation.

3. Take steps to advance restructuring and privatisation and improve the efficiency and corporate governance of companies with state ownership, notably in the Federation, to relieve the substantial burden on public finances.
4. Take steps to continue with the set-up of registry of para-fiscal fees to relieve burden on businesses without endangering the sustainability of public finances. Continue to reduce costs of business entry and exit and simplify the regulatory framework for the issuance of construction permits, especially in the Federation.
5. Reduce labour market rigidities by addressing disincentives to hiring, including taking further steps towards a reduction of the tax wedge while ensuring budget neutrality.
6. Finalize the development of a financial restructuring framework including to address the high burden of non-performing loans on bank balance sheets from both a stock and a flow perspective and thus help remove potential supply- and demand-side obstacles to credit extension. In this context, a strengthening of the crisis resolution framework would also appear warranted.

Concerning Part II of the ERP, Participants invite Bosnia and Herzegovina to:

7. Take steps toward the establishment of a single economic space by addressing the lack of internal coordination across all government levels.
8. Improve the business environment and support private sector development, including through the mutual recognition of business registration. Develop measures to provide targeted support for SMEs and to widen their access to finance. Tackle all forms of corruption, fraud and money laundering and informalities in the economy.
9. Develop a more strategic approach to tackle the deficiencies in the training and education system by effectively prioritizing measures based on a mapping of the skills gap taking into account the needs of industry, especially SMEs. Harmonise legislation and standards related to education and training at state and entity level, as well as at cantonal level, since the competence on education in FBiH is at cantonal level.
10. Develop a transport policy and strategy and an energy strategy at each level of government according to competencies, and embed them with the regional agenda on connectivity, including through the establishment of a credible planning of prioritized reforms with a timeline and funding mechanism (single project pipeline). The energy strategy should also consider substantial investments in a diversified power generation and on an effective distribution network.
11. Simplify the complex procedures for exports, ensure coordinated border controls and improve the border infrastructure system. Develop a comprehensive and strategic approach in the field of EU food safety and sanitary and phytosanitary standards to receive accreditation for exporting agricultural and food products to the EU.

Annex: Overall assessment of programme requirements

Bosnia and Herzegovina submitted its 2015 Economic Reform Programme, covering the period 2015-2017, with a short delay on 13 February 2015. 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 with more references to policy areas covered in the economic chapters of the European Commission's Progress Reports. In addition, it only broadly complies with the required content and form, as several inconsistencies between the text and the delivered data and most notably the lack of information on the implementation of the targeted policy guidance by the Commission as outlined in the letter from 30 June 2014 by the Commission's Vice President Olli Rehn to the authorities of Bosnia and Herzegovina, especially strike alongside with selective data gaps.

Macro framework

The presented macroeconomic framework in the 2015 ERP is broadly plausible even though the growth scenario is rather 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. In addition, the credibility of the presented medium-term programme would have benefited from a more thorough analysis of the downside risks and the links between the macroeconomic and fiscal assumptions and the structural reform measures have also been made more explicit. The 2015 ERP 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 a thorough quantitative elaboration of alternative scenarios as required by the programme,

Fiscal framework

The fiscal framework lacks a comprehensive description of medium-term measures beyond 2015, which would support the targeted consolidation and fiscal goals. In addition, the programme would have greatly benefited by the quantification of some briefly mentioned measures. The compilation and presentation of fiscal data is not yet fully in line with GFS methodology, while there are no roadmaps for the introduction of ESA95. Some data 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 main growth bottlenecks but fails to present a thorough analysis, as requested by the Commission. Moreover, in contrast to last year's programme, measures in several major areas with a pressing reform needs as the pension and health systems have been hardly touched upon. The structural reform strategy is vague on medium-term measures beyond 2015. There is an 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.

7. KOSOVO*

Box : *The first Economic Reform Programme (ERP) submitted by Kosovo was prepared within a set of very specific circumstances:*

The document was prepared in the interim period, as the formation of the new government after the June 2014 elections was delayed until December 2014. The drafting of the ERP also coincided with the kick-off of the work on the National Development Strategy (NDS). NDS is expected to be a multi annual planning document focusing on unlocking Kosovo's growth potential. ERP will in the following iterations thus serve as an annual report on implementation of the NDS priorities. Furthermore, the new government, formed in December 2014, drafted the 'Government Program 2015-2018' which due to time constraints could not be included in the 2015 Kosovo ERP. Thus the 2015 Kosovo ERP is based on the macroeconomic scenario outlined in the 2015 budget approved by the government in December 2014 and encompasses only measures which have already been approved by the government. The budget itself is based on the slightly modified scenario outlined in the Medium Term Expenditure Framework 2015-2017 document adopted by the former government in April 2014.

7.1. EXECUTIVE SUMMARY

Economic growth recovered in 2013 and Kosovo's economy is expected to have grown by even more in 2014, thanks to public wage and pension increases and higher remittances. However, political instability following the elections in June 2014, depressed growth by delaying capital investments and increasing the country's risk profile. In a slightly optimistic scenario ERP forecasts 3.3% GDP growth in 2014 and 4.3% on average between 2015 and 2017. These expectations rest on stronger private consumption and a surge in private investments. Substantial improvements in rule of law, public administration efficiency, resolving insolvency procedures, and enterprise governance practices, will be essential to attract investments and unlock still untapped financial system potential, and will require immediate decisive steps of the authorities. The main downside risks come from the country's weak capacity both to absorb external and fiscal shocks.

External vulnerabilities remain a defining feature of Kosovo economy, owing to its unproductive and narrow production base. The current account deficit, expected to stabilize around 6.5% of GDP, is dominated by a large trade deficit, and only partially offset by the inflow of diaspora worker remittances. Reliance on volatile and gradually decreasing FDI for financing, further stresses the importance of improving the investment climate and reopening the privatization agenda. If the ambitious level of investment forecasted for the period 2015-2017 were to materialise, it is likely that the current account would deteriorate, even though there have been some signs of import substitution. Should this happen, Kosovo would need to find alternative external financing as its foreign exchange reserves are inadequate.

Fiscal developments in 2014 were dominated by populist 25% increase in pensions and public wages. This led to an increase in current expenditures at the expense of growth enhancing investments. Revenues also fell, as economic activity weakened. The budget deficit nevertheless has been kept in line with the fiscal rule, however, this was largely achieved by delaying in certain capital investments. Ultimately, ad-hoc fiscal decision making has narrowed the scope for growth friendly expenditure consolidation in the coming years.

* This designation is without prejudice to positions on status, and is in line with UNSCR 1244/1999 and the ICJ Opinion on the Kosovo declaration of independence.

The budget for 2015 is based on a scenario which neglects negative developments in 2014 and predicts an unrealistic rise in revenue. Furthermore it envisages several major new spending initiatives, an increase in agricultural subsidies, the introduction of the new health insurance scheme and compensation for war veterans and wartime rape victims. With that in mind, the government should have additional expenditure consolidation contingency measures, beyond the announced VAT increase, prepared in case of adverse fiscal developments as failure to control the deficit could result in government's insolvency, given the narrow domestic bond market and lack of access to international markets. Therefore it would be advisable to examine a new arrangement with the IMF. To curb irresponsible fiscal behavior it will be essential to improve fiscal oversight with respect to long term fiscal sustainability and supplement this with control and enforcement mechanisms.

Kosovo economy faces persistent structural weaknesses which pose a considerable threat to the long term growth prospects. In particular, both the dysfunctional labour market and the low human capital endowment remain key concerns. Economic growth has so far been insufficient to improve labour market outcomes, namely the highest unemployment and the lowest activity rate in Europe. Despite flexible labour market legislation, reduction in unemployment is delayed by the sluggish reform pace in removing other obstacles to doing business, namely the slow and inefficient judiciary, widespread corruption and informality, low access to capital, and low capacity of public administration. Furthermore, as a result of the pass through effects to the private sector of the inappropriate public wage increases, Kosovo has largely exhausted its wage/ cost competitiveness advantage compared to its regional peers. The government has thus correctly identified attracting investments and improving the skillset of the workforce, through strengthening VET and higher education and fostering requalification and lifelong learning, as immediate priorities. On the other hand improving pre-primary and primary education will, in the long run, help Kosovo capitalize on the demographic dividend. The concrete policy reform agenda, however, remains inadequate and ill defined.

The financial sector remains stable, profitable and liquid but with ample room for deeper financial intermediation. Kosovo's financial system is characterized by high interest margin, a result of costly and inefficient insolvency resolution procedures, limited availability of sources of financing other than deposits, and overall high risk profile of the country. A large informal economy, poor corporate governance practices and prevalence of micro enterprises have caused large underutilization of the financial sector's resources. In the ERP the government recognizes reforms needed to fully utilize the financial sector but, aside from the introduction of the new bankruptcy law, the action plan for these reforms remains undeveloped.

7.2. ECONOMIC OUTLOOK AND RISKS

The ERP baseline scenario projects strengthening growth throughout the period 2014-2017, driven primarily by domestic demand. GDP growth is estimated at 3.3% in 2014 and is expected to accelerate to 4.1% in 2015, 4.3% in 2016 and 4.6% in 2017, with the main contribution coming from private consumption. The significant public wage and pension increases of April 2014 have boosted disposable incomes in 2014 and early 2015. Private consumption continues to be supported by expected stronger inflow of remittances (as the main diaspora countries i.e. Germany and Switzerland are projected to recover) and by stronger consumer lending. Investments contracted by 0.2% in 2014, due to the political instability, but are set to rebound throughout 2015-2017, growing on average by 7.7% per year. Due to the delayed implementation of public investments in 2014, the contribution to growth is expected to be negative in 2014, and due to fiscal constraints, will likely remain negligible throughout the period. Private investment on the other hand is expected to provide a significant push to GDP (8.7% growth over the forecast horizon), underpinned by rising FDI (8.7% per year throughout 2015-2017), domestic credit expansion and planned regulatory changes aimed at improving the investment climate. Net exports will continue to negatively detract from GDP growth but exports are projected to grow faster than imports owing to the recovery in main trading partners, a degree import substitution and export product diversification. On the production side the services sector is projected to grow by 5.7% over the forecasting period, driven by trade, transportation and IT. The programme expects a surprisingly strong growth in industry (on average by 8.6%), the underlying factors of which are not elaborated. Agriculture is seen to grow by 3.8% as a result of government subsidies, although the link is not convincingly established. The Construction sector is expected to grow by 4.4% on average, but its performance will heavily depend on progress in one major project, the construction of the highway R6 to Skopje.

Substantial downside risks to the execution of the baseline scenario exist both in the short and medium term. Kosovo's economy likely slowed in 2014. Delayed public investments, lower than expected FDI inflows and the cancellation of the Post and Telecom of Kosovo (PTK) privatisation, as well as political insecurity in the context of the general elections, put a break on growth. Consensus growth estimates for 2014 stand at 2.9% and will likely be further revised downwards. Consumption was expected to have kept a stronger pace following the wage and pension increases, but with a large import component and at the expense of public investments spending. However, disappointing data for H1 2014 show lower-than-expected growth and more importantly, no initial effect from higher disposable income on household consumption. As lower growth was expected in the second half of the year due to the political stalemate, it is likely that full year growth will be substantially below expectations. Risks to growth throughout the forecast period will arise from an investment climate made difficult by an inefficient judiciary, slow and expensive contract enforcement, and slow public administration. FDI has so far been highly volatile, decreasing, and primarily focused on real estate, construction, and banking. Therefore, to fulfil the optimistic growth forecasts of the industry sector, it will be essential to create an investment-friendly business environment and to attract greenfield investments in the tradable sectors. Consumption and investment may also be subdued by the delay in domestic credit expansion, which has so far been constrained by the high costs of contract enforcement and the limited availability of international credit lines. Continued restructuring of Publicly Owned Enterprises (POEs), and the privatisation of non-essential ones is necessary to capture total factor productivity gains and free fiscal space for needed capital investments. Substantial fiscal risks arise from the high share of current and pre-contracted expenditures, the narrow tax base, limited domestic and absence of international government financing. Non transparent ad-hoc policy making, primarily in pre-election times, and the lack of long term planning, increases the risk profile of the country and potentially discourages foreign investments. Therefore improving transparency and re-establishing the credibility of fiscal policy by preserving fiscal stability and sustainability should be of utmost priority. External risk could come from slower growth in main trading partners, such as the EU and CEFTA countries, particularly as remittances are heavily dependent on developments in Germany and Switzerland.

An alternative scenario developed in the ERP foresees slower growth due to delayed recovery in the EU. In this scenario, Kosovo's economy is expected to grow on average 2.5% throughout the period due to lower FDI and remittances inflows (primarily from Germany), which negatively affect private consumption and investment, and lower-than-expected growth in exports and imports (5% and 2% on average respectively). As a result of lower remittances, the current account deficit is expected to widen. The ERP, however, does not explain in detail the influence on the financing side of the balance of payments. Widening of the current account deficit coupled with lower FDI, low export coverage of imports (34%), and international reserves coverage of imports at 5.4 months, should increase the need for other sources of financing, which have so far been highly volatile and could prove difficult to obtain. This could lead to balance of payment financing difficulties, should such a scenario persists. The baseline scenario was prepared with German GDP growth slightly more pessimistic than projected in the latest Commission's winter forecast. Therefore its relevance for the alternative scenario should be limited. On the other hand, growth in Switzerland, the second largest diaspora country, was forecast without the latest shock to the Swiss franc's exchange rate. This scenario would also negatively affect fiscal revenues and increase the deficit beyond the limit set by the fiscal rule.

Inflation developments are outside of Kosovo's control. As a euro-ised economy heavily dependent on external supply, Kosovo price developments in Kosovo are heavily influenced by import prices, namely world food and energy prices. In 2014, Kosovo's CPI inflation was on average 0.4% with a clear declining trend towards the end of the year. Core inflation (non-food, non-energy) turned into deflation in the last quarter of 2014. Inflation prospects remain subdued, on average 0.5% throughout the forecast period.

Structural external imbalances are a perpetual vulnerability of the economy. A weak and unproductive economic base leaves Kosovo dependent on exporting crude materials and low value-added products and importing a wide range of consumer and capital goods. In 2013, the current account deficit narrowed further to 6.4% of GDP, due to a fall in goods imports following weaker domestic consumption and stagnating investment. In 2014, both exports and imports of goods recovered by 10.4% and 3.6% respectively, driven by spillover effects from recovering export partners and stronger domestic demand. The ERP foresees that the current account deficit stabilising around 6.5% of GDP over the forecasting period, with exports and imports growing by 5.6% and 5%, respectively. Worker remittances, which traditionally dominate the net transfers account, are expected to increase by 4.8% on average. Keeping in mind an ambitious investment plan in 2015-2017 (7.7% average growth of investments), underpinned by the construction of the new Route 6 highway and the announced construction of the 'New Kosovo Power Plant', it is more realistic to expect a gradual deterioration of the current account balance towards 2017. Despite some signs of import substitution, namely in agriculture and construction material, this is unlikely to fully offset a rise in investment-related imports.

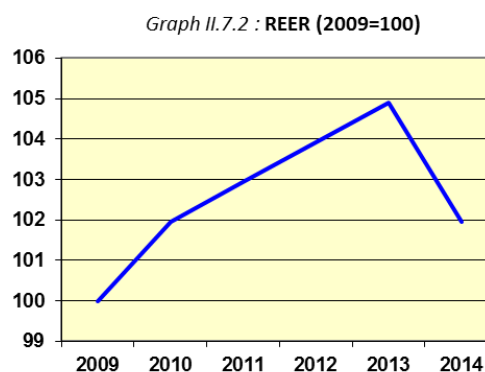
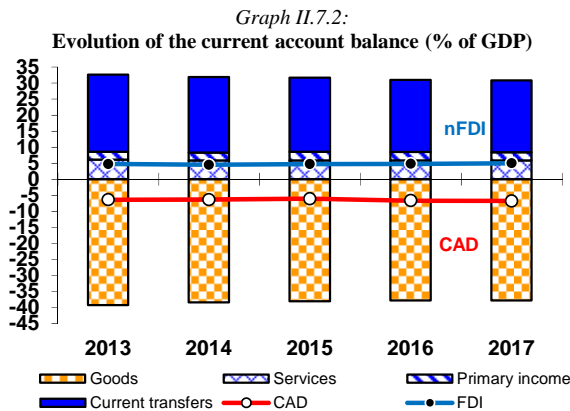
Table II.7.1:

Macroeconomic developments and forecasts

	2013	2014	2015	2016	2017
Real GDP (% change)	3.4	3.3	4.1	4.3	4.6
<i>Contributions:</i>					
- Final domestic demand	2.3	4.0	5.5	5.7	6.1
- Change in inventories	0.0	0.0	0.1	0.0	0.0
- External balance of goods and services	1.2	-0.7	-1.4	-1.4	-1.5
Employment (% change)	11.7	3.2	1.8	2.2	2.0
Unemployment rate (%) LFS	30.2	29.0	28.7	28.1	27.4
GDP deflator (% change)	1.8	1.5	1.2	0.3	0.2
CPI inflation (%)	1.8	0.8	0.4	0.6	0.4
Current account balance (% of GDP)	-6.4	-6.3	-6.1	-6.6	-6.8

Sources: National Economic Reform Programme (NERP) 2015

The financing side of the balance of payments remains heavily dependent on volatile and gradually decreasing FDI. In 2013 FDI recovered, reaching 4.5% of GDP. Available data for the first three quarters of 2014 show a 44.5% decrease in net FDI inflow, namely due to backtracking of the privatisation agenda and political uncertainties related to the elections. The ERP scenario optimistically estimates a 0.4% reduction in FDI in 2014 and an average growth rate of 8.7% throughout the period. Since 2009 the majority of FDI went to the real estate, construction, and banking sectors.



Source: National Economic Reform Programme (NERP) 2015, ECFIN

Changing the pattern towards greenfield investments in tradable production sectors will require broad-based reforms aimed at attracting FDI, some of which are outlined in the ERP, like tax incentives, strengthening the legal system, improving access to finance, and combating the informal economy. In this context, furthering the privatisation agenda would seem of utmost importance.

Despite an optimistic growth forecasts, the effect on sorrowful labour market conditions remains negligible. The labour market remains characterized by stubbornly high unemployment and low participation rate (30.2% and 40.5% in 2013 respectively). Employment is expected to increase on average by 2% in the forecasting period. However, given the growing working age population (1.3% on average) stronger growth will be required to absorb this inflow and substantially improve labour market outcomes. Unemployment is projected to decrease to 27.4% by 2017. However the activity rate is expected to remain unchanged (40.5%) throughout the forecasting period. Therefore, there is little prospect for a marked lowering of the absolute number of unemployed. Furthermore, the structural profile

of the unemployed, with high long term and youth unemployment, is projected to remain unchanged and in itself calls for a reflection on appropriate labour market policies.

Table II.7.2:

Financial sector indicators

	2010	2011	2012	2013	2014
Total assets of the banking system, mEUR	2,455	2,650	2,830	3,059	3,187
Credit growth	13.2	16.4	3.8	2.4	4.2
Bank loans to the private sector					
Deposit growth	11.0	8.6	8.3	7.5	3.6
Loan to deposit ratio	75.31	80.71	77.38	73.74	74.21
Financial soundness indicators					
- non-performing loans	5.9	5.7	7.5	8.7	8.5
- net capital to risk weighted assets	18.8	17.6	14.2	16.8	18.0
- liquid to total assets		30.9	30.6	33.4	33.4
- return on equity		16.6	10.4	10.6	18.5
- forex loans to total loans	0.0	0.0	0.0	0.0	0.0

Sources: National Central Bank, DataInsight

The banking sector remains stable, liquid and profitable, but also heavily underutilised. In 2014, the total assets of the banking sector grew by 4.2% mainly due to the recovery of credit growth towards the end of the year. Corporate loans are still dominated by loans to the retail sector (53.4%). However, the composition could somewhat change in the upcoming period as the government starts with investment promotion policies. In 2014, loans to the manufacturing sector grew by 13% and loans to the construction sector contracted by 12.2%. The banking sector remains well capitalised with a capital adequacy ratio at 18%, liquid, with a liquidity ratio at 44.8%, and profitable, with growth in profits of 131.1% compared to 2013, and ROAA and ROAE at 1.9% and 19.9% respectively. The loans to deposit ratio and the bank loan to GDP ratio stood at 74.2% and 34% respectively indicating ample potential space for further financial intermediation. The ERP scenario foresees credit growth slightly above the 2014 level throughout the forecast period. Credit demand should increase as a result of higher growth while the banking sector should be able to provide adequate supply due to its sufficient capital and liquidity buffers and relatively low level of NPLs (8.5%).

7.3. PUBLIC FINANCE

Budget execution in 2014 was affected by lower growth and ad hoc pre-election spending. Revenue collection underperformed across almost all revenue categories mainly due to lower- than-expected economic growth (projections were based on a growth forecast of 4.1%). Preliminary data suggest that total revenues in 2014 were EUR 1,333 million or 8.6% lower than planned. Border tax revenues underperformed by 6.9%, mainly due to delays in public investments and hence lower imports of capital goods. Planned one-off payments from the Privatisation Agency of Kosovo (PAK) and the Kosovo Pension Saving Trust (KPST) were not realised and caused a loss of 17.3% in domestic taxes. Own source revenues were 16.2% smaller than planned, largely due to the underperformance of municipal revenues. Overall expenditure amounted to EUR 1.463 million or 7.9% lower than forecasted primarily because of the under-execution of capital expenditure (EUR 118.7 million less than planned). On the other hand, current expenditures substantially overshoot their targets, due to the 25% increase in public wages and pensions (50% for Trepca miners) in April 2014. Wages and salaries spending increased by 16.3% compared to 2013 but stayed within the planned amount. Subsidies and transfers rose by 15.4% overshooting the budget by 15%. The composition of spending was thus shifted towards non-

discretionary spending (72% of total spending in 2014 compared to 64.4% in 2013) leaving less space for investments and fiscal adjustments. The total budget deficit amounted to EUR 121.9 million or 2.2% of GDP. Although above the 2% threshold implied by the fiscal rule, the deficit is not considered a breach of the rule as provisions in the law provide for exceptional circumstances in which revenues drastically underperform. The financing side of the budget has not yet been fully disclosed but available data show that public debt reached 10.6% of GDP in 2014, up from 8.9% at the end of 2013.

The stated core objective of fiscal policy in 2015-2017 is the preservation of the stability of public finances. The fiscal rule implemented in 2014 will provide an important anchor, limiting the deficit to 2% of GDP and setting the long-term public debt level ceiling to 40% of GDP. Kosovo has a relatively simple tax system with few exceptions and low tax rates. It is thus understandable that the ERP fiscal scenario does not foresee any tax rate changes⁽¹⁾, but focuses instead on broadening the tax base and fostering tax compliance. Nevertheless, revenues are expected to increase as the efficiency of tax collection improves and more is done to tackle the informal economy. To that effect, the government will continue with activities foreseen in the action plan for the implementation of the 'National Strategy for the prevention and fight against informal economy 2014-2018'. On the expenditure side, the government is determined to accommodate the latest April 2014 wage and pension increases. The fiscal framework does not envisage any additional increases of wages, pensions or social benefits. With the aim of increasing spending efficiency, the government has announced that it will continue to follow a restrictive spending policy on goods and services while preserving a high level of capital investment (around 7% of GDP).

Table II.7.3:

Composition of the budgetary adjustment (% of GDP)

	2013	2014	2015	2016	2017	Change: 2014-17
Revenues	24.7	23.9	26.8	25.6	24.8	0.9
- Taxes and social security contributions	22.5	21.7	23.8	23.2	22.5	0.8
- Other (residual)	2.2	2.2	3.0	2.4	2.3	0.1
Expenditure	27.8	26.4	28.9	27.4	26.6	0.1
- Primary expenditure	27.6	26.2	28.6	27.0	26.2	0.0
<i>of which:</i>						
Gross fixed capital formation	9.9	7.4	7.8	7.3	7.3	-0.1
Consumption	11.9	12.4	13.3	12.5	11.9	-0.4
Transfers & subsidies	5.9	6.5	7.5	7.2	6.9	0.5
Other (residual)	-0.1	0.0	0.1	0.1	0.1	0.1
- Interest payments	0.2	0.2	0.3	0.4	0.4	0.1
Budget balance	-3.1	-2.6	-2.1	-1.8	-1.8	0.8
Budget balance as per fiscal rule	-3.1	2.2	2.0	2.0	2.0	n.a.
Primary balance	-2.9	-2.3	-1.8	-1.5	-1.4	0.9
Gross debt level	9.0	10.6	12.4	13.4	14.5	3.9

Sources: National Economic Reform Programme (NERP) 2015, ECFIN calculations

Due to the political deadlock, the 2015 budget is based on a now unrealistic scenario outlined in the MTEF 2015-2017. The assembly adopted the new 2015 budget in January 2015, targeting a fiscal deficit EUR 113.3 million⁽²⁾ or 2% of GDP, in line with the fiscal rule. The budget is based on nominal and real GDP growth in 2015 of 5.4% and 4.1% respectively, and CPI inflation of 0.4%. Total revenues are expected at EUR 1.578 billion (26.8% of GDP), 8.1% higher compared to the 2014 budget plan⁽³⁾ and

⁽¹⁾ Several tax system measures, with substantial fiscal impact, were mentioned in the structural reform part of the NERP but they were not included in the fiscal scenario.

⁽²⁾ Fiscal rule takes somewhat adjusted overall budget deficit. Capital expenditure financed by privatization receipts are deducted from the deficit, provided that the level of usable government bank balance amounts to at least 4.5% of GDP.

⁽³⁾ Budget expenditure growth rates are expressed in comparison to the 2014 budget plan unless stated otherwise

18.3% higher than the actual amount in 2014. The largest revenue increase should come from higher tax receipts. Domestic tax receipts and border taxes are expected to increase by 17% and 3% respectively, as a result of increased economic activity and payment of planned but not collected one-off revenues from PAK and KPST. Expenditures in 2014 are planned at EUR 1.699 billion, 5.8% higher than the 2014 budget plan and 15.1% higher than released in 2014. The budget for wages and salaries will increase by 15.9% to EUR 60 million as a result of the full-year effect of the wage increases (21 million), introduction of the health insurance contribution for public employees (10 million), payments with regard to implementation of the collective agreement with public workers (11 million), and the cost of filling the existing vacant positions for numerous budget organisations. Expenditure for subsidies and transfers (including subsidies and transfers to POEs) are planned at EUR 438.7 million or 39.7% higher than in 2014. Social transfers are budgeted to increase by around 40% to EUR 417 million due to the full-year effect of the pension increases, the start of the implementation of the law on war veterans, and agricultural subsidies (EUR 41 million). The capital expenditures budget is expected to decrease by 13.9% to EUR 457 million, and will primarily be allocated to the construction of the Highway Road 6 to Skopje project (90 million EUR), M2 road to Mitrovica/Mitrovicë and M9 road to Peja/Peć.

Budget revenue and expenditure expectations throughout the forecasting period are identical to the ones outlined in the 2015 budget and hence do not fully reflect the measures laid out in the recently-approved Government Program 2015-2018. Following the increase in 2015, total revenue is supposed to decrease as a share of GDP (from 26.8% in 2015 to 24.8% in 2017). Growth of customs revenue is expected to start decreasing in 2016, reflecting the beginning of the implementation of the Stabilization and Association Agreement (SAA) with the EU and slower import price inflation. Lower growth of border revenues is to be partially offset by domestically collected revenues, which are projected to rise as the tax base broadens and consumption increases. Overall tax revenue is to decrease as a share of GDP from 23.8% in 2015 to 22.5 in 2017. Budget expenditure is also set to decline as a share of GDP to 26.6% in 2017 compared to 28.9% in 2015. Following increases in spending in 2015, all budget categories, except interest payments, are expected to decrease in relation to GDP throughout the forecast period. Budget expenses from the introduction of the mandatory health insurance contribution are expected to gradually rise from EUR 10 million in 2015 to EUR 18 million in 2017. Cost of implementing the public administration reform is estimated at EUR 18 million in 2016 and 2017. Capital expenditures will be dominated by Road 6 construction spending (EUR 288 million over the 2015-2017 period), and rehabilitation of the railways (EUR 30 million).

The macro-fiscal scenario carries substantial risks and the 2015 budget deficit is likely to exceed the threshold implied by the fiscal rule by a wide margin. Based on the MTEF 2015-2017 adopted, back in April 2014, the ERP fiscal framework does not take into account the discouraging growth and fiscal developments of 2014. More optimistic growth forecast for 2015 (4.1% compared to the consensus 3.2%) provides a downside risk, along with overestimated budget revenues (18.3% rise compared to the 2014 budget execution) which might be difficult to accomplish without stronger growth. Empirical evidence on revenue elasticity suggests that revenue growth is likely to be much lower; given the 5.4% nominal growth projected in 2015, and expected EUR 37 million in one-off revenues. Projected gains from improved revenue collection and fight against informal economy are best treated as windfall revenues as international experiences show they are often overestimated. In such a scenario, keeping expenditures constant, the budget deficit could easily increase far above the threshold implied by the fiscal rule. Financing such high deficits could prove difficult if the situation persists, given the narrow domestic bond market, the lack of access to international markets, and limited treasury reserves. Following recent increases in public wages, pensions and other social transfers' increases, the share of current expenditures will leave fiscal consolidation with little room for manoeuvre. Although the alternative scenario outlined in the ERP assumes similar but less extreme developments, no concrete measures of fiscal adjustment have been outlined. Savings will probably be sought among the growth-supporting capital expenditures, but some of them have already been contracted. Against this background, it seems essential to develop contingency measures that could be immediately deployed in case of less benign fiscal developments. Measures should avoid the easiest course of action, delaying capital projects, and tackle the real problem

of unsustainably high level of current expenditure and narrow tax base. By the end of March the government announced a basic VAT rate increase to 18% (16% now), however, net effects of the measure will likely be mitigated by introduction of a lower 8% rate for basic commodities and other tax exemptions. On the expenditure side, a comprehensive revaluation of the latest wage and pension increase, announced agricultural subsidies as well as non-targeted social transfers would be welcome. Furthermore, a substantial risk arises from disproportionately low budget allocation for the construction of the Route 6 highway, given the value of the total project (660 million EUR) and the obligation to completely pay it by 2018. Amid all aforementioned fiscal risks, a new program with the IMF should be considered more so, as refinancing 103 million EUR of IMF loans is coming due by 2017.

Table II.7.4:

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

	2013	2014	2015	2016	2017
Gross debt ratio [1]	9.0	10.6	12.4	13.4	14.5
Change in the ratio	0.9	1.6	1.8	1.0	1.0
<i>Contributions [2]:</i>					
1. Primary balance	2.9	2.3	1.8	1.5	1.4
2. “Snow-ball” effect	-0.2	-0.2	-0.2	-0.2	-0.3
<i>Of which:</i>					
Interest expenditure	0.2	0.2	0.3	0.4	0.4
Growth effect	-0.3	-0.3	-0.4	-0.5	-0.6
Inflation effect	-0.1	-0.1	-0.1	0.0	0.0
3. Stock-flow	-1.8	-0.5	0.2	-0.2	-0.1

Notes:

[1] End of period.

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

Source: National Economic Reform Programme (NERP) 2015; ECFIN calculations

Institutional public finance framework needs further strengthening. A fiscal rule and the Law on Public Finance provide the backbone of public finance management in Kosovo. However, the nascent fiscal regulatory framework is deficient in enforcement and monitoring mechanisms. Repetitive ad-hoc fiscal decision making, with large fiscal impact, such as but not limited to, commitment to large infrastructure projects and across the board wage and pension increases, although by chance deficit neutral in 2014, presents the main risk to budget credibility and fiscal sustainability, and should be legislatively discouraged, especially in election years. Establishing a fiscal council or an independent fiscal agency, with a mandate to preserve long term fiscal sustainability and reduce deficit bias, both politically motivated and due to overly optimistic macroeconomic scenario, is recommended. Budget planning procedures have so far been in transparent and uncoordinated, and budget spending programs fail to present links to governments immediate and long term priorities. To improve public finance management Ministry of Finance has announced improvements in public procurement procedures and better control of contracting procedures on the local level.

Public debt is low but remains sensitive to refinancing and fiscal shocks. At the end of 2014 public debt stood at 10.6% of GDP, 1.6 percentage point higher than in 2013. Around 44% of the debt is domestically issued, in the form of short maturity treasury bills and bonds (up to two-year maturity), while the rest is mainly held by the IMF (EUR 103 million) and the World Bank (EUR 208.9 million)⁽¹⁾. Average weighted interest rate (2.6% in 2014) is projected to slightly increase in the short term, as Kosovo starts issuing domestic bonds of longer maturities; and over the longer horizon, as Kosovo

(¹) IMF and World Bank figures stand at the end of September 2014.

gradually shifts from concessional loans to market issued international debt. Interest rate expenditures are thus expected to increase from 0.2% of GDP in 2014 to 0.4% in 2017. The debt level is expected to reach 14.5% of GDP with the main determining factor of the debt evolution being the budget deficit. The prevalence of short term debt in total debt poses a potential refinancing risk. The government plans to issue EUR 200 million of foreign debt throughout the forecasting period, the majority of which will be to refinance the EUR 103 million IMF loan in 2016 and 2017. Potential creditors or the conditions of this new borrowing are not explained in the ERP, aside from the note that its purpose is financing of budget projects, and that it does not foresee additional financial assistance from the IMF. Domestic bond and treasury bill issuance is expected to amount to EUR 320 million cumulatively in the next three years, an amount which could pose a risk of crowding out lending to private sector. In case of a larger fiscal shock, like the one discussed earlier, the government could face a financing constraint and become insolvent, given the narrow domestic market and inability to access international markets. Furthermore, government deposits, which could potentially be used as a source of financing in case of emergency, are currently below the level implied by the fiscal rule (4.5% of GDP) and are expected to fall to only 2% of GDP by 2017. The long-term public debt sustainability analysis presented in the ERP shows, a very limited room for deviations from the rules implied by the fiscal rule.

7.4. STRUCTURAL REFORMS

The economy of Kosovo faces significant obstacles to growth, which are well recognised in the ERP, and suffers from low competitiveness. Despite favourable macroeconomic conditions (high growth and stable inflation), low taxes, and flexible labour markets, Kosovo has been unable to fully unlock its growth potential, primarily due to political instability, weak rule of law, widespread corruption, inefficient public administration, and the prevalence of unfair competition from the informal economy. These obstacles to growth discourage foreign investors and increase the costs of doing business, as is evident from the very high intermediation spreads of the financial sector. High costs of domestic capital constrain access to finance and further discourage investment. Additional supply side constraints arise from inadequate infrastructure, unreliable energy supply (exemplified by frequent power shortages), and a lack of adequately educated workers.

Kosovo urgently needs improvements to its business environment. To improve the efficiency of public administration, the Government plans to implement and adopt several laws outlined in its Better Regulation Strategy. The implementation of the Law on Permits and Licenses will streamline the number of permits and licenses required by businesses and place safeguards to restrict the issuance of unnecessary regulation. A number of laws are in the process of being adopted. The Law on Inspection is expected to reduce the number of costly unnecessary inspections, especially for SMEs, while the Law on Administrative Procedures defines procedures for handling appeals and complaints in accordance with the EU best practices. The Law on Liquidation and Reorganisation of Legal Persons in Bankruptcy is expected to improve access to finance for businesses by strengthening insolvency resolution practices. The continued implementation of the National Backlog Reduction Strategy is expected to foster contract enforcement by reducing the civil case backlog and freeing up court resources. Expected quantitative results from the aforementioned measures are not fully explained in the ERP.

The Government Program 2015-2018 envisages changes to the tax system which were not incorporated in the ERP scenario but are aimed at incentivising domestic production, attracting investment and improving the efficiency of the tax administration. Measures to increase domestic production foresee the introduction of lower tax rates for basic commodities, the introduction of the zero-rate for agricultural products and lowering the VAT threshold to 30,000 EUR (now EUR 50,000). It should be noted that the effects of such policies will likely remain modest due to the prevalence of micro enterprises in the Kosovo's economy, a number of which continue not being included in the VAT system. Lowering VAT rates will therefore have little effect on their competitiveness and will also be applied to imported goods, thus limiting import substitution. On the other hand, lowering the VAT threshold will

decrease the competitiveness of the new VAT payers especially in the retail sector. Investment promotion tax measures include tax holidays to companies which invest and employ workers above yet undefined thresholds and new customs exemptions for IT equipment. No estimations of forgone tax collections are given and the expected surge in IT sector investments in the short run is implausible, given the limited supply of highly-educated IT experts. Tax efficiency measures focus on encouraging the introduction of fiscal cashiers and merging the revenue collecting agencies (i.e. Tax Administration of Kosovo and Kosovo Customs) but fail to address below potential performance of property tax collection.

No further development of the privatisation agenda is envisaged. Although the ERP outlines sectors which will in future be opened to private sector participation (water and waste, telecommunication and railway services), no concrete action plan for privatisation is given. This represents an additional backtracking of the privatisation agenda following last year's cancellation of PTK privatisation.

The Investment and Employment Fund measure proposed in the ERP raises more questions than answers. A measure continuously mentioned throughout the election campaign, aims at concentrating and enhancing available funds, distributed across several government programs and donor-supported projects, for domestic business support. The Government Program 2015-2017 envisages mobilisation of these funds, together with the privatisation funds (i.e. privatisation proceeds held by PAK), in support of the real economy. The detailed evaluation of the project will require more information, but sole mentioning of the 'mobilisation of the privatisation fund⁽¹⁾' sets a dangerous precedent. Assuming it concerns the trust funds administered by PAK, such a fund would contravene the Law on the Privatisation Agency of Kosovo, Article 5, which establishes the autonomy of the PAK in carrying out its functions and responsibilities, It would also contravene Article 19, paragraph 3, which states that funds held by PAK are to be invested only in assets with an international investment grade. Furthermore, any attempt to misuse assets held by PAK or limit its autonomy would undermine credibility of the privatisation agenda and endanger PAK's ability to satisfy valid claims from creditors and owners of the sold, transferred or liquidated enterprises in its portfolio.

The financial system is stable but its legal and regulatory frameworks need updating to accommodate international best practices. Amendment and development of regulatory and supervisory frameworks is planned regarding the prevention of money laundering and the financing of terrorism, supervision of insurance companies and pension funds, financial services consumer protection, mortgage loans and evaluation of mortgages, and fulfilling Basel II and Basel III requirements for the banking sector. No new measures are foreseen in the ERP as those mentioned are either already being implemented or are in the final stages of preparation. The financial system will, however, benefit from measures to improve contract enforcement, establish effective bankruptcy procedures, and strengthen dispute resolution mechanisms.

The ERP correctly identifies structural weaknesses of the labour market and establishes strengthening active labour market policies as the proper way to address them. Kosovo's labour market is characterised by its high flexibility, low tax burden and limited use of collective wage bargaining. Nevertheless Kosovo's relative wage/ cost competitiveness is not so pronounced as the minimum (EUR 170) and average gross wages (EUR 370) are comparable to the regional peers and even to some EU member states, such as Bulgaria and Romania. Some credit for relatively high wages in Kosovo can be attributed to pass-through effects to the private sector from the ad-hoc increases in public wages. Therefore it is essential to tie public wage increases only to developments in economic fundamentals. Without clear labour costs advantages, Kosovo will have to compete on the education and skills of its labour force, which is lagging behind. To that end the ERP outlines several initiatives with the goal of bridging the gap between labour market needs and the education and training system⁽²⁾. Additional

⁽¹⁾ Kosovo 2015 ERP, page 47

⁽²⁾ Measures are outlined in Part II of the ERP but they are also discussed here as they have a potential impact on the macro fiscal framework

attention was paid to active labour market policies and improving the employability of unemployed people. In general, the measures are vaguely explained, without a concrete results matrix and without budget allocations. With the poor results of the labour market in mind, the overall impression is that the proposed measures are cosmetic at best. Funding for employment services and vocational training, however insufficient, is additionally fragmented across several entities and the announced plan to merge them under the new Agency for Employment is left without budget allocation in the 2015 budget. Kosovo has a high natural unemployment rate due to its high cost of doing business and low-skilled workforce. The former can be addressed by cutting red tape, adopting policies to promote investment and employment, and incentivising formalisation of informal economic activity. Addressing the latter will require substantial investments in quality (pre)primary, VET and high-level education but is essential for improving labour market outcomes and capitalizing on the demographic dividend in the long term.

The government has approved a new health insurance scheme to improve health sector results. Starting in 2015, the new health insurance law creates a Health Insurance Fund (HIF), a mandatory health insurance scheme, which will be funded by a payroll tax at 7% divided equally by the employer and the employee. All other non-exempt individuals will be required to pay a flat monthly premium of two euros with exceptions for the poor and other vulnerable individuals. A total of EUR 80 million is expected to be collected from the contributions and the government has already appropriated EUR 10 million in the 2015 budget for employee premium payments. The estimated full-year amount needed for the current number of public employees and level of gross wages is closer to EUR 18 million. No additional budget transfers to the HIF are envisaged. However fiscal risks exist as eventual losses incurred by the HIF would certainly have to be serviced by the budget or would lead to accumulation of arrears. Furthermore, few other measures aimed at increasing health spending and improving its efficiency, are outlined in the Government Program 2015-2018 but have not been budgeted.

Public sector spending reforms should be focused on increasing productivity. The ERP clearly states that no new ad-hoc public wage increases are envisaged in the forecast period, but the credibility of such statement would be strengthened by concrete policy measures, especially amid growing fiscal pressures. The existing public administration reform is expected to be extended into 2015 and 2016 for which EUR 18 million has been appropriated under wages and salaries budgetary organisation. As the appropriations for this reform in 2014 were used to accommodate the wage rise, it is essential not to further delay the introduction of new job classifications and the new upgrade of the reform. Announced increases in agricultural subsidies could prove to be a potent tool in reducing poverty and social exclusion in rural areas but only if a strong link with productivity gains is established. Subsidies should be directed at fostering entrepreneurial initiative in agriculture and complimented with measures to exploit economies of scale and improve access to capital and product markets.

7.5. The 2015 policy guidance

Joint conclusions of the Economic and Financial Dialogue between the EU and the Western Balkans and Turkey

Economic and Financial Affairs Council meeting
Brussels, 12 May 2015

[.../...] concerning part I of the ERP, Participants hereby invited Kosovo to:

1. Sustain the commitment to fiscal discipline and improve transparency of public finances by considering establishing an independent fiscal council, or fiscal agency, with a clear mandate to preserve sustainability of public finances, and reduce deficit bias, and by better coordination between government and parliamentary bodies responsible for budgetary processes. Improve the budget process by legislatively strengthening the role of the Medium Term Expenditure Framework and enshrine principles of cost-benefit analysis as the basis of the policy planning process. Take steps to increase government deposits to the threshold implied by the fiscal rule (4.5% of GDP) to provide additional financing buffer.
2. Address immediate fiscal risks with necessary measures aimed at reducing unsustainably high current expenditures while preserving growth enhancing capital spending. Develop a legal framework for maintaining a sustainable public wage bill and strengthen targeting and means testing of transfers. Ensure planned increases in agricultural subsidies are directed exclusively at productivity increasing initiatives. Advance public administration reform with special attention on improving productivity and reducing costs. Take further steps in strengthening public finance management practices.
3. Modernize revenue collection to reduce reliance on customs receipts by improving property tax collection and strengthening the legal framework for collection of tax and municipal tax arrears. Revisit local government grant financing scheme to incentivise better collection of municipal revenues. Further broaden tax base by introducing the planned mandatory health sector contributions, and reassess planned tax exemptions.
4. Advance restructuring and restart the privatization of non-essential Publicly Owned Enterprises (POEs). Take steps to improve the efficiency and corporate governance of strategic POEs. Address the lack of quorum of the board of Privatization Agency of Kosovo (PAK) and accelerate privatization of Socially Owned Enterprises still in PAK's portfolio.
5. Address the underlying causes for high costs of bank-based financing, reduce the duration and cost of insolvency procedures by adopting the new bankruptcy law and further improve contract enforcement with a view to increase overall financial intermediation in the economy.

Concerning part II of the ERP, Participants invite Kosovo to:

6. Strengthen government oversight and consider setting up an advisory body to contribute to the assessment of future major infrastructure projects, including their fiscal impact and make sure they align with the regional agenda on connectivity (core network). Advance towards securing a reliable energy supply while ensuring the compliance with the EU environmental standards in the production of energy.
7. Improve the quality of education by continuing to roll out teacher licencing and training as well as improving quality assurance and strengthening related incentives; improve access to pre-primary and primary school education; accelerate modernization of vocational education, continue improve quality

of higher education and improve focus on aligning the education system so as to make it more responsive to the labour market. Assure the timely operationalisation of the recently established Public Employment Service and its effectiveness in lowering the high unemployment rate.

8. To improve the business environment and continue with the clearing of court backlogs, strengthening capacities of judicial system, and developing cadastre databases. Advance measures to tackle informality in line with the strategy for the prevention and fight against informal economy, including incentives to reduce undeclared work. Reduce the administrative burden for business by implementing the Better Regulation Strategy and the Law on Permits and Licences. Develop measures to provide targeted support for SMEs and to widen their access to finance. Step up the fight against corruption and efforts to improve public procurement, by enhancing administrative capacity, increasing efficiency and effectiveness of the Public Review Board, and implementing central procurement.
9. Facilitate trade by amending the Customs Code and adopting new legislation on customs enforcement of IPR.
10. Adopt a holistic approach to Foreign Direct Investment that anchors supportive policies in a strategic framework and focus on removing existing obstacles. Increase investor protection by developing an investor after-care program and establish an investor grievance mechanism.

Annex: Overall assessment of programme requirements

The first Kosovo Economic Reform Programme covering the period 2015-2017 was submitted on 30 January 2015. The programme was approved by the government following a roundtable discussion with representatives of NGOs and business associations and is in line with the previously approved medium-term fiscal strategy. Taking into account that this is the first programme of this kind that Kosovo submits to the European Commission, it presents an overall decent quality in terms of content, structure, and analytical approach. The document generally complies with the requested format but lacks a comprehensive assessment of the impact of the proposed structural reforms on the macro-fiscal framework. Such estimates have only been done for two measures which have both already been planned and budgeted before the development of 2015 budget.

Macro Framework

The presented macro-fiscal framework in the 2015 ERP is broadly plausible despite growth estimates for 2014 and 2015 being optimistic, compared to the consensus forecasts. External assumptions have been taken from the IMF October World Economic Outlook which bears some differences compared to the latest EC winter forecast. Assumed growth in the EU, Eurozone and Germany in particular, in 2015 has been slightly underestimated in the ERP while inflation estimates are slightly higher. Downside risks to the scenario execution come from unrealistic fiscal framework, namely from overly optimistic budget revenue estimate. Developed alternative scenario rests on lower than expected growth in the EU, namely Germany, and Switzerland. Although useful to showcase Kosovo's fiscal vulnerabilities, the alternative scenario does not address most obvious risks to the economy.

Fiscal Framework

Fiscal framework rests on now outdated MTEF 2015-2017 fiscal scenario which was, due to time constraints, also adopted for the 2015 budget. It envisages an implausible 18.3% rise in revenue in 2015, compared to 2014 budget execution. Weaker growth of revenue will surely lead to greater fiscal deficit than planned, unless revenues and expenditures are adjusted in the mid-term budget revision. No new expenditure based measures have been approved and only already approved fiscal measures have been accounted for in the fiscal framework leaving little or no description of medium-term measures beyond 2015.

Structural reforms

The programme correctly identifies main reform areas but fails to present a coherent and detailed set of measures. Only two measures (introduction of the Health Insurance Fund and the public administration reform), which were already planned or have been in implementation in 2014, have outlined fiscal impact. Other measures mentioned are a mixture of measures from the newly adopted Government Programme 2015-2018 and ongoing reforms. Their descriptions are largely vague without any estimates of their fiscal impact, timeline of execution, or quantification of expected results.

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