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2009 Economic and Fiscal Programmes of potential candidate countries: EU Commission's assessments

Directorate-General for Economic and Financial Affairs

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European Commission

Directorate-General for Economic and Financial Affairs

2009 ECONOMIC AND FISCAL PROGRAMMES OF POTENTIAL CANDIDATE COUNTRIES: EU COMMISSION'S ASSESSMENTS

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INTRODUCTION

In this Occasional Paper the Directorate General for Economic and Financial Affairs publishes its overview and assessments of the 2009 Economic and Fiscal Programmes (EFP) of the potential candidate countries (Albania, Bosnia and Herzegovina, Montenegro and Serbia).

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

For this reason a similar, though reduced, exercise was started in 2007 with the potential candidate countries, with the submission and assessment of annual EFPs as important element.

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

The 2009 EFPs were submitted between mid-October 2008 and 1 December 2009. All programmes have been made public by the countries and can be found on the internet under following addresses:

Albania	http://www.minfin.gov.al/downloads/Economic%20and%20Fiscal%20Program%202008%20-%202011.pdf
Bosnia and Herzegovina	http://www.dei.gov.ba/Default.aspx?pageIndex=1
Montenegro	http://www.gom.cg.yu/eng/minfin/vijesti.php?akcija=vijesti&id=172049
Serbia	http://www.mfin.sr.gov.yu/eng/2742/

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1. OVERVIEW

1.1. SUMMARY AND CONCLUSIONS

Bosnia and Herzegovina, Montenegro and Serbia submitted by 31 January 2009 *Economic and Fiscal Programmes* (EFPs). The Albanian programme was received on 2 February. The preparation, assessment and discussion of these programmes serve to strengthen economic planning capacity in the countries as such and to prepare them for the next step, i.e. participation in the economic and fiscal surveillance procedure of candidate countries and, eventually upon the more distant perspective of accession, in the economic policy co-ordination and budgetary surveillance mechanisms of the Economic and Monetary Union (EMU).

The recently submitted programmes represent a step forward towards meeting this objective. They generally contain useful overviews of economic policy plans on a broad range of issues over the next few years. In particular they show the determination of the governments to advance further stabilisation, structural reforms and productivity gains in order to allow sufficiently high growth, catching up with the EU Member States and raising standards of living in the countries. The degree of ambition and precision in policy implementation across the programmes is not uniform.

The 2009 EFP exercise has been complicated by the intensification of the global economic and fiscal crisis since autumn 2008. At the time when the national authorities prepared the EFPs, it was less clear through which channels and to what extent the countries of the Western Balkans would be affected by the current crisis. During the last couple of months of 2008 and in January 2009, it became increasingly obvious that the economic slowdown of Western Europe, the main trading partner for the Western Balkan countries, is resulting in a decline of external demand for goods and services produced in the region. Furthermore, the tightening of credit conditions in global markets, following the collapse and near collapse of systemic banks in the US and Europe, has already slowed the very fast credit growth rates previously recorded in the Western Balkan countries and is expected to weigh on the refinancing of their high external imbalances.

In addition, all EFPs rely on external assumptions for economic growth, trade and commodity prices provided by the European Commission or the International Monetary Fund, which were published in late 2008, but were already outdated by the time of the submission of the programmes at the end of January. Therefore, the macroeconomic and fiscal-frameworks are in general too optimistic, , except for those programmes which provided alternative and more pessimistic scenarios.

This exercise of submitting, assessing and discussing annual EFPs will continue to support the countries on their way towards European integration. The EU is in a position to provide an important anchor in this effort. A closer integration of this form of pre-accession economic and fiscal surveillance with other instruments of pre-accession economic policy communication, i.e. the economic chapters of the Progress Reports and European Partnerships and the bilateral economic dialogues with the countries, can increase their effectiveness in this respect. Technical assistance in the area of economic policy planning and implementation has also proven a powerful tool in the case of candidate countries and might be more amply mobilised for the potential candidate countries.

1.2. BACKGROUND

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

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

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

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

1.3. THE 2009 ECONOMIC AND FISCAL PROGRAMMES

Countries were requested to submit their programmes by 31 January 2009. All countries broadly complied with this deadline and all programmes have been made public by the countries authorities.¹

Overall,

- the four programmes present generally consistent and ambitious policy frameworks for economic stabilisation, fiscal policy and structural reform. Their methodology and presentation has improved in several instances compared to last year's submission. However, some have deteriorated in quality and not all authorities appear fully committed to the exercise. In all four programmes, there is room for further improvement. In general, all countries are committed to strengthen administrative capacities and, in the longer run, to prepare for eventual participation in the economic policy co-ordination and budgetary surveillance mechanisms of Economic and Monetary Union.
- all programmes are based on rather optimistic macroeconomic and fiscal frameworks. Against the backdrop of a rapid deteriorating global economy, the potential candidate countries continue to project annual output growth between 2.5% and 7% over the programme period (table). The submitted programmes were prepared at a time when the impact of the current crisis on the Western Balkan countries was not yet fully explicit. As a result, growth projections are likely to be too optimistic. Albania and Bosnia-Herzegovina foresee a continuation of annual economic growth over the programme horizon at about 6.5% and 6.0%, respectively. The Montenegrin EFP provided three alternative growth scenarios. Under the most pessimistic scenario, which appears

⁽¹⁾ Albania: <http://www.minfin.gov.al/downloads/Economic%20and%20Fiscal%20Program%202008%20-%202011.pdf>
Bosnia and Herzegovina: <http://www.dei.gov.ba/Default.aspx?pageIndex=1>
Montenegro: <http://www.gom.cg.yu/eng/minfin/vijesti.php?akcija=vijesti&id=172049>
Serbia: <http://www.mfin.sr.gov.yu/eng/2742/>

the most realistic, growth accelerates from 2.5% in 2009 to 4.5% in 2010. The Serbian EFP projects an acceleration of growth from 3.5% in 2009 to 6.0% in 2010;

- the scenarios foresee that in all countries growth will over 2009-2011 be mainly driven by recovering domestic demand. However, risks to the programmes are substantially more significant than last year, mainly due to the deteriorating global economic backdrop, which could result in substantially lower exports and reduced capital inflows in the form of loans and FDI; these limited financing means, while helping the correction of current account imbalances, could severely affect economic activity and growth in 2009. Most programmes foresee a rather rapid recovery starting already in 2010. One of the common risk to these programmes is thus that, instead of a V-shaped growth profile, the recovery will take more time in view of the magnitude of adjustments needed;
- the monetary frameworks foresee no changes to the respective current frameworks, i.e. quasi-inflation targeting in Albania and Serbia, a currency board in Bosnia and Herzegovina and official euroisation in Montenegro;
- most fiscal frameworks project a substantial improvement of the fiscal balance over the programme horizon, but appear to strongly underestimate short-term risks to the budget likely to materialise already in 2009, in particular on the revenue side. Over the programme period, the Albanian budget balance is projected to remain in deficit, but to improve by a total of 2.2 percentage points of GDP. While Bosnia and Herzegovina foresees an almost balanced budget in 2009, the fiscal improvement amounts to a total of 3.0 percentage points of GDP between 2008 and 2011. For Serbia, the fiscal balance is projected to remain negative but to gradually improve by a total of 1.3 percentage points of GDP. These projections now appear as rather optimistic, given the fact that fiscal revenues in most countries have started showing signs of substantial decline in January 2009. For Montenegro, the crisis scenario seems the most realistic, projecting a sharp increase of the budget deficit in 2009 and a decline thereafter, resulting in a total fiscal deterioration of 2.1 percentage points of GDP over the programme horizon. As a result, the debt-to-GDP ratio for Montenegro is expected to grow by 12 percentage points to 40% by 2011. For Albania and Serbia, the debt ratio (based on optimistic growth assumptions) is foreseen to decline by 2.5 percentage points to 52% of GDP and by 3.0 percentage points to 27% of GDP, respectively by 2011. Bosnia and Herzegovina did not provide data on consolidated public debt-to-GDP;

Table I.1.1:

2009 Economic and Fiscal Programmes: Key indicators

	2007	2008	2009	2010	2011
Growth (GDP, real, ann. % change)					
Albania	6.0	7.2	6.0	6.7	6.9
Bosnia and Herzegovina	12.1	5.6	5.7	6.1	5.7
Montenegro	10.7	8.1	2.5	3.5	4.5
Serbia	7.1	6.0	3.5	4.5	6.0
Unemployment rate (% of LFS)					
Albania	13.2	12.5	12.3	11.8	10.2
Bosnia and Herzegovina	29.0	23.4	25.4	27.3	26.8
Montenegro	11.9	10.7	11.6	10.6	9.5
Serbia	18.8	18.8	19.0	18.7	18.2
Current account balance (% of GDP)					
Albania	-10.6	-11.6	-10.5	-9.2	-8.0
Bosnia and Herzegovina	-12.6	n.a.	n.a.	n.a.	n.a.
Montenegro	-29.8	-34.1	-20.9	-21.4	-24.7
Serbia	-14.7	-18.3	-16.3	-15.7	-14.4
Inflation (CPI, annual % change)					
Albania	2.9	3.4	2.7	3.0	3.0
Bosnia and Herzegovina	1.5	8.3	5.5	4.5	3.7
Montenegro	7.7	8.0	5.0	3.5	3.0
Serbia	6.8	11.1	8.2	7.2	6.2
Government balance (% of GDP) *					
Albania	-3.5	-5.3	-4.2	-3.3	-3.1
Bosnia and Herzegovina	1.2	-2.0	-0.1	0.7	1.0
Montenegro	6.3	1.4	-2.4	-1.7	-0.7
Serbia	-2.0	-2.0	-1.4	-1.1	-0.7
Government gross debt (% of GDP) *					
Albania	53.0	54.8	55.2	53.8	52.3
Bosnia and Herzegovina	8.4	n.a.	n.a.	n.a.	n.a.
Montenegro	27.5	27.8	41.2	40.7	39.7
Serbia	31.3	30.0	28.6	27.8	27.0

* general government, national accounting standards

Source: EFP 2009

- the structural reform agendas, as presented in the EFPs, cover a broad range of areas and reveal a varying degree of ambition. In Albania the reforms focus on the improvement of the business environment as the main objective, including strengthening incentives for the domestic creation of new undertakings and rendering Albania more attractive for FDI. The programme of Bosnia and Herzegovina covers reforms in the enterprise and financial sectors, labour market, public administration, the pension systems, health care, education and transport sector. Montenegro's emphasis is put on the enterprise sector, the financial sector, the labour market and administrative reforms. The programme of Serbia focuses on a wide range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. Often, however, the EFPs are very detailed when describing past developments while rather vague when explaining intended reform measures. Furthermore, the EFPs would have benefitted from a more explicit discussion of the links of structural reforms to the macroeconomic and fiscal frameworks. Only Montenegro's 2009 EFP fares better in this respect.

1.4. CRISIS RELATED POLICY ISSUES

In the context of the present dramatic deterioration of the global economy, the discussion on the appropriate policy responses has to take into account the specific situations in each affected country. In the case of the potential candidate countries important common elements are:

- Fiscal policy options are very limited in all countries, also in view of the pro-cyclical policies of recent years. While external imbalances remain high, although adjusting rapidly in the course of the current crisis, restrictive fiscal policies will need to further support the much needed adjustment process. The crisis related decline in public revenues and limited prospects for realising privatisation proceeds, reduce the scope for financing fiscal expenditures and deficits, while access to foreign financing via international capital market has become more expensive. The cost for domestic financing has increased as well, due to high domestic interest rates, often increased to support the domestic currencies. In some countries already relatively high debt levels prohibit increasing public debt, as solvency issues may arise.
- Any room for increasing taxes is often limited by an already high degree of taxation in several countries; further tax increases could adversely impact medium-term growth prospects. At the same time, expenditure will continue to increase in several countries, due to permanent expenditure increases in 2008, mostly for public sector salaries and pensions. These antagonistic developments will exert substantial pressures on public finances in the coming year.
- In addition, structural reforms that may have sizeable budget effects, in particular enterprise restructuring and privatisation, need to be put on top of the policy agenda, with a view to cut wasteful subsidies to unviable enterprise and increase privatisation revenues.

To enhance the countries' resilience to the crisis, improvements in the prioritisation of budget expenditure and revenue measures could play a key role, in particular by better targeting those measures that contribute to the functioning of the market economy and to raising the countries' competitiveness. In case additional counter-cyclical public expenditure are approved, they will need to be financed from savings elsewhere in the budget. Overall, establishing the appropriate policy mix has become significantly more challenging than in previous years, which makes the pursuit of a prudent fiscal policy even more important.

1.5. THE EFPS AND PRE-ACCESSION STRATEGY

The programmes lay out policy strategies which are to a large degree compatible with and conducive to the fulfilment of the economic priorities of the European Partnerships. Overall, the full and determined implementation of the announced reforms should strengthen the countries' economies, in particular in view of the fulfilment of the Copenhagen economic accession criteria, i.e. establishing a functioning market economy and raise competitiveness to a level which would allow the countries to meet competitive pressure within the European Union. In some cases, though, clearer and more convincing information on the specific implementation of these objectives would have been useful, e.g. as regards ways to improve market exit mechanisms which remain highly inefficient throughout the region, or the prioritisation of public investment to raise the countries' competitiveness.

1.6. FOLLOW-UP

The programmes and their assessments by the Commission services was discussed within an experts meeting on 29 April in Brussels, with experts from the potential candidate countries, EU Member States and the European Central Bank.

This exercise has been, since its start, an annual one. Therefore, the countries will again be invited to submit next year a programme for 2010-2012.

Part II

Country analysis

1. ALBANIA

SUMMARY AND CONCLUSIONS

The Economic and Fiscal Programme (the 2009 EFP) sets out the medium-term framework of economic and fiscal policies in Albania. It aims at consolidating public finances with a view to meeting the Maastricht criteria by 2011, while maintaining a high level of public investment. The programme is a welcome policy coordination instrument which is based on several medium-term government strategies. Compared to its previous versions, the programme displays an increasing budget and project planning capacity, as well as an improved quality and availability of statistics. The 2009 EFP complies with the requirements on format and content of the European Commission.

Growth during the first two quarters of 2008 continued to be strong, before a deceleration was observed in the third quarter. The programme assumes continued strong growth of 6% in 2009, picking up further in the outer years. Inflation came in slightly higher in 2008 at 3.4%, up from 2.9% in 2007. The EFP assumes annual inflation to reach 2.7% in 2009 and 3% for the outer years 2010 and 2011, in line with the mid-range of the Central Bank's range of inflation rates that are compatible with its goal of maintaining price stability. The EFP assumes a narrowing of the current account deficit from 11.6% in 2008 to 10.4% in 2009 and further on to 7.9% in the final year of the programme. Compared to the previous EFP, the adjustment of the external imbalance starts from a substantially higher level in 2008, which implies a significant increase in overall financing requirements. While this scenario is plausible on the basis of the external assumptions used, it does not adequately reflect the increased risks with respect to growth, price developments, and the financing constraints of the current account deficit in the context of the international financial and economic crisis.

The government deficit is estimated to have reached its target of 5.2% of GDP in 2008, after having attained 4.3% in 2007. The EFP foresees a reduction to 4.2% in 2009, and then further on to 3% in 2011. The reduction in 2009 is solely based on increased revenues, whereas expenditure as a share of GDP is kept at previous levels, before the expenditure share is somewhat reduced in the outer years of the programme. These deficit targets result in the debt to GDP ratio increasing to 55.2% of GDP in 2009, up from an expected 54.8% of GDP in 2008, before the ratio starts falling again to reach 52.3% of GDP in 2011. On the basis of the external assumptions underlying the programme, the public finance scenario is adequate and supports the programmes policy goals as well as the achievement of the targeted policy-mix. However, the programme lacks quantitative information on fiscal risks, especially those risks that relate to public revenues and the evolution of the public debt and its financing requirements.

The programme adequately describes Albania's structural and institutional reform agenda. It shows that institutional reforms in the area of the tax administration and budgetary institutions at large had a substantial positive impact on public finances, i.e., the buoyancy and the efficiency of the revenue system as a whole. The ambitious agenda of structural reforms includes a near finalisation of the government's privatisation agenda and a large array of improvements for doing business in Albania. It is crucial for Albania as a business location that this reform agenda continues also after general elections in June 2009, independent of the exact composition of the incoming government.

The programme, while not implausible in principle, does not seem very balanced in terms of distribution of risks, the bulk of which seem to accrue on the fiscal side. Overall, the programme seems to underestimate the risk of a stronger than foreseen contraction of domestic demand due to lower than expected net remittance flows and/or lower or delayed net capital inflows, notably FDI. Investments may further suffer from a gloomier outlook for the export oriented industries in the mining sector as well as in the inward processing sector. Altogether, with downward risks to the

macroeconomic framework clearly outweighing upward risks, real GDP growth could be halved in 2009 and turn out lower in 2010 as well. Another risk comes in the form of general elections in June 2009 which are poised to delay any corrective measures (including in the context of a possible IMF programme) until after the elections, even in the case where such measures would become necessary at an earlier stage.

Compared to the previous EFP, the document is less consistent, partly because adjustments to the macro-fiscal framework have been made in an ad-hoc manner. The programme's structural and institutional reform agenda is well integrated into the macro-fiscal framework and fully aligned with European Partnership priorities and requirements originating from the implementation of the Stabilisation and Association Agreement (SAA). No major policy shifts are foreseen and the government continues to implement reforms on an ongoing basis. The EFP does not yet contain an explicit policy reaction to the international economic and financial crisis, but some precautionary measures, such as an increased contingency line in the budget to provide some additional flexibility and a tightening of the regulatory framework for banks and other financial institutions, signal a prudent and forward-looking approach to crisis management on the side of the Albanian authorities.

1.1. INTRODUCTION

In July 2006, the European Commission invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia for the first time to submit by 1 December 2006, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes (PEP) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

Albania's third EFP was submitted timely on 2 February 2009, covering the period 2008-2011. It is based on several policy documents such as the Program of Government 2007-2010, the Medium Term Budget Program 2010-2012, the Sectoral Strategy for Public Finances and the National Strategy for Development and Integration (both 2007-2013). It continues to reflect to a considerable degree a policy framework which had been underlying the three year Poverty Reduction and Growth Facility arrangement and the Extended Fund Facility arrangement with the IMF since 2006, and which has been successfully concluded with its sixth and final review on 28 January 2009, including the disbursement of its final tranche. In its description of structural reforms, the 2009 EFP is documenting the sustained effort to approach the *acquis communautaire*, to implement European standards, and to live up to the requirements stemming from the implementation of the SAA.

The programme is broadly compliant with the guidelines of the European Commission. A detailed summary of recent macroeconomic developments is presented, a medium-term macroeconomic and fiscal framework is projected and an extensive list of structural reforms is provided. The description of the monetary policy setting provides detailed analysis. Too little emphasis is put on the quantification of fiscal risks that are identified in the programme. The authorities explicitly mention several scenarios diverging from the baseline one, but no quantitative results of this sensitivity analysis are provided in the document.

The programme foresees the continuation of a dual strategy: (i) fiscal and structural policy measures aim to reduce the cost of doing business, notably by lowering statutory rates of taxes and social security contributions, while they also foresee a broadening of the tax base (e.g., by fighting tax evasion) and lower requirements for setting up and running a business activity; (ii) monetary policy continues to pursue price stability and to monitor the stability of the financial sector. The authorities expect the international economic slowdown to have only a limited negative impact on growth and

assume a return of a favourable economic environment already by 2010. The public debt to GDP ratio increases in 2009, but is expected to decrease in the outer years of the programme. Structural reforms focus on approaching the *acquis communautaire* via the implementation of European Standards.

1.2. ECONOMIC OUTLOOK

1.2.1. Recent macroeconomic developments

Growth was strong in recent years, recently published quarterly estimates point to real GDP growth of 6.9% in 2007, up from 6.2% in 2006 and 6.3% in 2005. Growth during the first two quarters of 2008 continued to be strong, before a deceleration was observed in the third quarter. Inflation came in slightly higher in 2008 at 3.4%, up from 2.9% in 2007. The current account deficit worsened to 11.6% of GDP in 2008, after 10.5% in 2007. The EFP assumes a narrowing of the deficit to 10.4% in 2009 and further on to 7.9% in the final year of the programme. The labour market continued to improve on all indicators (employment, unemployment rate, productivity), in spite of substantial increases in real labour incomes and unit labour costs. The programme covers well the main recent developments in the economy, while remaining data gaps point to the need to further strengthen the statistical system, including its statistical governance.

Table II.1.1:
Macroeconomic developments

	2007	2008	2009	2010	2011
Real GDP (% change)	6.0	7.2	6.0	6.7	6.9
<i>Contributions:</i>					
- Final domestic demand	9.7	11.0	5.5	7.7	7.6
- Change in inventories	1.5	-1.7	0.7	-1.1	-1.2
- External balance of goods and services	-5.2	-2.1	-0.2	0.1	0.5
Employment (% change)	0.4	2.3	1.2	2.6	3.7
Unemployment rate (%)	13.2	12.5	12.3	11.8	10.2
GDP deflator (% change)	3.3	3.9	2.5	3.2	3.3
CPI inflation (%)	2.9	3.4	2.7	3.0	3.0
Current account balance (% of GDP)	-10.6	-11.6	-10.5	-9.2	-8.0

Source: EFP 2009 submission

However, in order to reach 7.2% of real GDP growth in 2008 as envisaged in the programme, growth in the fourth quarter would have to be similar to growth in the third quarter (+1.3% vis-à-vis Q2/2008). On the one hand, the trade balance worsened sharply in the fourth quarter; on the other hand a disproportionate share of public investment tends to be implemented in the last quarter, boosting GDP. Overall, the expected rate of economic growth of 7.2% for 2008 may be optimistic. In general, the programme provides no detailed information on the economic impact, albeit limited until its submission, of the global economic and financial crisis (see box).

1.2.2. Medium-term macroeconomic scenario

The macroeconomic framework presents a coherent, consistent and sufficiently comprehensive view of the Albanian economy over the programme period. The programme aims at continued high growth of more than 6% in the medium-run, declining external imbalances and a sufficient degree of price stability, while keeping the budget deficit low enough to allow for a declining debt ratio. To achieve

Box II.1.1: The global financial crisis: First impact and policy response

The impact of the international economic and financial crisis on the Albanian economy so far has been limited to those sectors that are most directly linked to international trade developments. This is confirmed by public revenue data for the first two months of 2009. Public revenues in Albania were only 4% below budgeted revenues in the first two months of 2009. While customs revenue (incl. VAT in imports) was down by 15%, domestic revenue collection performed slightly above target. Among the vulnerable sectors is the mining industry, where some export markets, e.g. chromium to China, have according to the Albanian authorities shut down completely and the inward processing sector with around 400, mainly Italian and Greek owned, small and medium-sized enterprises. The authorities are aware of the difficulties in those trade-exposed sectors and aim to avoid negative impacts on employment by directly providing financial aid to these sectors. However, the EFP does not give any detailed information on such measures, nor does it state their budgetary costs. Only indirectly, the government has put a figure on the expected size of the overall impact by increasing the contingency line in the 2009 budget to 2% of GDP. The Central Bank has continuously tightened regulation and strengthened its surveillance, while using available monetary space in early 2009 to lower its benchmark rate by 50 basis points to 5.75%.

The Albanian lek has depreciated since the end of 2008 by 6% against the euro and by 8% against the U.S. dollar. The Bank of Albania (BoA) intervened in February on the back of intense pressures on the lek. By that time, the turnover volume in the FX market had contracted by around two thirds, possibly reflecting lower trade and remittances (as a matter of fact, officially recorded remittances fell to levels corresponding to those in early 2004, whereas between 2004 and mid-2008, they had been globally increasing). The intervention by the BoA aimed primarily to stop the one way operations on the lek exchange rate and to stimulate supply. It also aimed at decreasing the volatility of the exchange rate and smoothening the rate of the lek's depreciation. The BoA intervention took place throughout the first half of February and had a volume of around 1-1.5% of FX reserves. Since then, the FX market has been more stable, exhibiting higher volumes and lower volatility.

The share of non-performing loans (NPLs) as a percentage of total loans has increased in the last quarter of 2008 to 6.5%. Profitability has been decreasing in 2008, but only partly due to higher NPLs, which in the fourth quarter necessitated higher provisioning. Other factors lowering profits in the sector were an increased competition for market share, first via lending rates, then later in the year also via deposit rates. Also, higher refinancing costs have started to affect profit margins as well. The rate of return on equity (ROE) stood at 11.4% in Q4 of 2008.

Further on, by mid-March, the government has raised guarantees on bank deposits to EUR 25,000. The new guarantee covers more than 80% of all bank deposits.

these objectives, it envisages an ambitious public investment agenda and a continued lowering of the tax burden.

The medium-term strategy represents a sensible policy-mix that under the programme's assumptions is realistic and should be implemented. However, with a rapidly deteriorating international economic environment, the fiscal space for further tax reform may not be available to the extent envisaged in the programme, and public investments may have to be scaled back in order to rein in the budget deficit in 2009. Furthermore, the assessment of risks to the macroeconomic scenario is insufficient. The existence of substantial risks is acknowledged, not the least by the fact of keeping a 2% of GDP contingency line in the budget 2009, but none of the risks is explicitly quantified in terms of budgetary consequences. To some extent, this lack of quantitative information may be motivated by the existence of a delicate equilibrium in the market with respect to interest rate and exchange rate developments which the Albanian authorities try to preserve.

Real sector

The economic outlook sticks to the assumption of 6% of real growth in real GDP in 2009 as envisaged in the previous programme. However, the growth composition has changed with domestic demand contributing only 5.5%, down from 6.7%. On the other hand, the negative contribution from net exports shrinks to -0.2%, down from -0.7% a year earlier. The main assumption of the economic outlook is that even against the background of a much less favourable economic environment, private consumption expenditure will remain sustained. Investment growth slows substantially and public consumption is assumed to add very little to growth in 2009. The latter does not seem to be consistent with the fact that a targeted increase of public wages (with priority on health and education sectors) continues in 2009-2011, after substantial increases were implemented already in 2008. Thus, public consumption growth could be stronger than envisaged in the programme.

The improvement of labour market indicators is slower in 2009 before resuming its previous speed in 2010 and 2011. The programme assumes continued, albeit slower, employment growth, unemployment stable at 12.3% in 2009 (after falling continuously over the last couple of years), before falling further to 10.2% in 2011. Productivity growth remains strong and represents the main driver of economic growth. Albania's potential growth rate is typically seen at around 6%. In that respect, the economic outlook for 2009 and 2010 is on the optimistic side. Taking the revised global outlook into account, growth in 2009 could be rather 2-3%, before returning to trend by 2011. Even such a reduced rate depends on i) the successful implementation of the envisaged policy mix and ii) external risks to the outlook not fully materializing (e.g., a dramatic slowdown of net remittance flows in 2009 and beyond).

Inflation

Albania has managed to keep inflation rates at adequate levels. Even during the 12 months of a hike in international commodity and energy prices (between August 2007 and July 2008), the inflation target of Bank of Albania (BoA) of 3% +/- 1% was only slightly breached. It is noticeable that this increase in inflation was very modest in comparison with other countries of the region and even in comparison with some members of the euro area. During this period, BoA raised its core policy rate several times by a total of 75 basis points, from 5.5% to 6.25% until November 2007 and kept it at this level throughout 2008. Survey data show that inflation expectations could be successfully anchored within the BoA's target band. From August 2008, year-on-year changes of the monthly averages of the CPI were back to figures below 3% and rates continued to fall, reaching 2.2% in December 2008, followed by 2.1% in January 2009. The EFP assumes annual inflation to reach 2.7% in 2009 and 3% for the years 2010 and 2011, in line with the mid-range of the Central Bank's inflation target. This outlook is realistic on the basis of external assumptions used, but inflation could turn out even lower in the short-run, if global demand continues to weaken.

Monetary and exchange rate policy

Albania sticks to its exchange rate regime of a free float. Money market interventions are limited to softening sharp movements in the exchange rate, while BoA rules out any efforts to stabilize the exchange rate over the medium- or long-run. The base interest rate will continue to be the main tool for anchoring inflation expectations of market participants. The growth of money supply is used as an intermediate target, managed via the setting of the repo rate and by open market operations. However, monetary policy faces an important constraint in the form of currency substitution. A substantial amount of deposits and loans are held in foreign currencies (mainly euro and U.S. dollar). The spreads of interest paid on deposits and loans held in those currencies with interest paid on deposits and loans held in the local currency lek are closely monitored. In addition, the Bank of Albania aims to further the development of the domestic financial system and the level of financial intermediation which, albeit increasing fast in 2007 and 2008, still remains at a moderate level. The country's monetary

policy stance continues to be appropriate and represents an important element of stability of the overall macro-fiscal medium-term framework.

External sector

The external deficits widened substantially compared to the previous programme's projections. According to the 2009 EFP, the current account deficit will reach 11.6% of GDP in 2008, up from 10.6% in 2007. The previous EFP had a projection of 8.4% and 8.3% for 2007 and 2008 respectively and expected a narrowing to 5.5% of GDP in 2009. The current programme now expects a current account deficit of 10.5% of GDP, i.e., almost double the figure of the previous programme. This dramatic worsening of the external account is fully explained by the widening of the trade deficit. At the same time, the Bank of Albania keeps the stock of foreign exchange reserves at levels sufficient to finance roughly 4 months of imports (goods and services). The programme foresees a narrowing of the current account deficit starting in 2009 and leading to a deficit of 8% of GDP in 2011. The current EFP assumes a much more favourable development of the services balance than the previous version, whereas remittance flows are revised down by around 30% for the period 2009-2011. Notwithstanding the size of these changes on the external accounts, the programme does not discuss them, which is clearly inadequate. In particular, remittances may experience a sharper drop as labour markets in host countries deteriorate rapidly, which would likely negatively impact on imports.

Recorded foreign direct investments (FDI) came in somewhat higher than expected in 2007 and 2008 at 5.9% and 5.5% of GDP, respectively. The EFP assumes FDI to stay at around 5% of GDP between 2009 and 2011. While this outlook is plausible against the backdrop of the Commission autumn forecast's assumptions, foreign direct investments may be delayed as a consequence of tighter credit and increased uncertainty about demand developments. A further risk to the FDI projection lies in the assumption that the bulk of the expected FDI is of the green field type, whereas FDI in recent years was fuelled by the government's privatisation programme. Lower FDI and external financing flows would heavily constrain economic growth and imply a narrowing of current account deficits. Overall, the discussion of projected financial and capital account developments is not sufficiently detailed in the programme.

Main risks to the macro-economic scenario

Overall, the programme is poised to underestimate the risk of a stronger than foreseen contraction of domestic demand, e.g., due to lower than expected net remittance flows and/or lower or delayed net foreign direct investment flows. Investment may further suffer from a gloomier outlook for the export oriented industries in the mining sector as well as in the inward processing sector. Furthermore, the macroeconomic scenario, while not implausible in principle, does not seem very balanced as risks mainly accumulate on the fiscal side. A quantification of such fiscal risks would have better substantiated the potential effects of the international economic and financial crisis. Altogether, with downward risks to the macroeconomic framework clearly outweighing upward risks, real GDP growth could be halved in 2009 and turn out lower in 2010 as well. Another risk is related to general elections in June 2009 which may delay corrective measures (including a possible IMF programme) until after the elections, even if such measures would become necessary at an earlier stage.

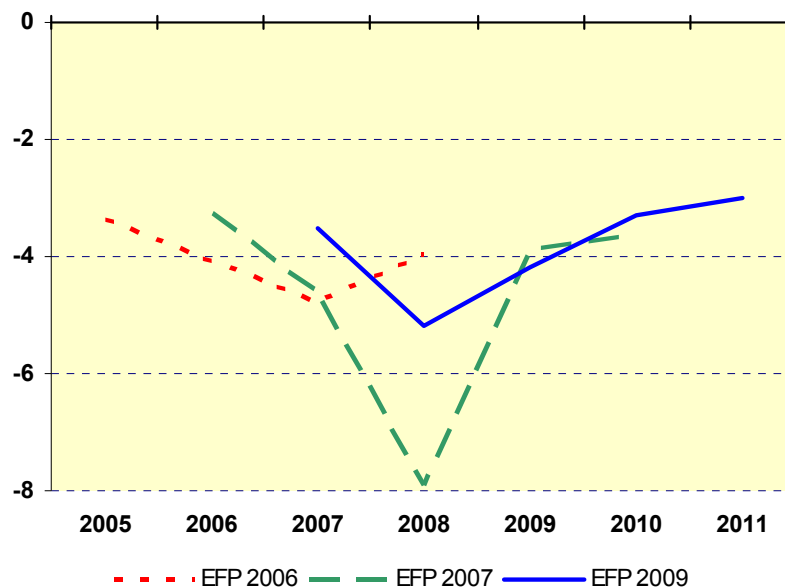
1.3. PUBLIC FINANCE

The fiscal framework is well integrated into the overall economic policy strategy and adequately addresses European Partnership priorities (without explicitly referring to them). The presented fiscal framework is sufficiently comprehensive and consistent, but it lacks coherence with the medium-term economic outlook, as the estimation of fiscal revenues does not appreciate economic developments affecting the various tax bases to a sufficient degree. The revenue side of public finances as a whole is

not well anchored to macroeconomic projections. The programme explains well policy measures that were implemented over the last two years including their effect on revenues. For the remainder of the government's Public Finance strategy 2007-2013, the major policy measure is the reduction of social security contributions paid by employers from 20% to 15%, with an estimated cost of 0.4% of GDP. Customs tariff levels will be lowered in accordance with trade agreements (e.g. CEFTA), but no estimate of budgetary costs is provided.

The analysis of fiscal risks is insufficiently developed, as several risks are mentioned (notably the interest rate and refinancing risk), but quantitative information on the results of sensitivity analysis is not provided. The dependence of the fiscal outlook on the structural reform agenda is not immediately clear. The fiscal revenue projections assume a continued strong increase in the efficiency of the overall revenue system. While this effect was clearly present in 2008 and has contributed to a remarkable buoyancy of the tax system, strong efficiency gains cannot be assumed to go on forever. A simple plausibility check of revenue elasticities reveals an implicitly assumed buoyancy of the revenue system that is not plausible. As a result, the outcome of fiscal revenues may turn out to be substantially below projections. Especially in 2009, with an expected sharp drop in trade volumes and possibly remittances, forecasting another improvement of similar size could prove overly optimistic. Possible privatisations receipts, the main structural reforms with budgetary effects relate to the privatisation agenda, were not included in the budget. While this is a financing component of the deficit (i.e. below the line), indicative amounts would have been welcome in view of the substantial deficits and considerable refinancing needs of public debt maturing over the programme period, in particular in 2009. The programme does not mention to what extent fiscal data are compatible with ESA 95.

Graph II.1.1: Budgetary developments (general government balance, % of GDP)



The fiscal year 2008 saw a substantial increase in both revenues and expenditures as a percentage of GDP. On the revenue side it consisted mainly in tax revenues, on the expenditure side the increase was almost entirely due to the widening of public capital spending. The fiscal strategy in the updated

EFP makes these level shifts permanent. The size of revenues as a share of GDP increases further and public investment stabilizes on the higher level. With tax revenues growing stronger than expenditures, the deficit is continuously reduced until it reaches 3% of GDP in 2011. The debt ratio increases slightly to 55.2% in 2009 before decreasing to 52.3% in 2011.

1.3.1. General government balance and debt

Actual balance and medium-term perspectives

The government deficit is expected as planned at 5.2% of GDP in 2008. Previously, the 2008 budget had foreseen a deficit of 7.9%, which was later reduced to 5.2% of GDP in agreement with the IMF, partly by scaling down public investment. Nevertheless, the acceleration of public investment in 2008 remained impressive. After 6.5% of GDP in 2007, on-budget capital expenditure reached 9.3% of GDP in 2008. This increase has exceeded the increase in revenues by 1.6% of GDP in the 2008 budget execution.

Also in 2008, the tax reform of direct taxes on personal income and on profit was finalized (including the introduction of a flat rate of 10%). Together with the lowering of the statutory tax rate, the administration of the personal income tax was radically simplified by the introduction of so-called reference salaries, i.e., minimum floors for the applicable individual tax bases. Apparently, this has helped to substantially increase tax compliance as revenues from this tax increased in spite of the lower rate, pointing to typical "Laffer curve" effects. However, the 14% decrease in revenues from the tax on profits is in line with expectations as the aim of this part of the tax reform was to effectively lower the tax burden on businesses (whereas the reform of the personal income tax increased the effective tax burden on individuals). As part of the reform, several exemptions were abolished with the aim to increase transparency and reduce administrative costs. Another goal of the tax reform was to narrow the gap between the non-taxed agricultural sector and all other sectors of the economy. The 2008 budget execution implemented several reforms in the application of excise taxes with current practise converging on existing ones in the European Union, resulting in higher revenues from excise taxes.

Table II.1.2:
Composition of the budgetary adjustment (% of €

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	25.8	27.4	28.4	28.6	28.7	1.3
<i>of which:</i>						
- Taxes and social security contributions	23.6	24.9	26.0	26.2	26.5	1.6
- Other (residual)	2.2	2.5	2.4	2.4	2.2	-0.3
Expenditure	29.3	32.7	32.6	31.9	31.8	-0.9
<i>of which:</i>						
- Primary expenditure	26.7	29.8	29.5	29.0	29.0	-0.8
<i>of which:</i>						
Gross fixed capital formation	6.5	9.3	8.8	8.3	8.0	-1.3
Consumption	10.1	10.5	10.1	10.3	10.4	-0.1
Transfers & subsidies	9.1	8.9	9.8	9.4	9.2	0.3
Other (residual)	0.9	1.1	0.9	1.1	1.3	0.2
- Interest payments	2.6	2.9	3.1	2.9	2.8	-0.1
Budget balance	-3.5	-5.3	-4.2	-3.3	-3.1	2.2
Primary balance	-0.9	-2.4	-1.1	-0.4	-0.3	2.1
Gross debt level	53.0	54.8	55.2	53.8	52.3	-2.5

Sources: EFP 2009 submission

For 2009, the EFP foresees a reduction of the deficit to 4.2% of GDP. This reduction is solely based on increased revenues, whereas expenditure as a share of GDP is kept at previous levels. As a results

of the planned deficit, the debt to GDP ratio increases to 55.2% of GDP in 2009, up from an expected 54.8% of GDP in 2008. The 2009 budget intends to keep a high level of capital spending. On the expenditure side, the 2009 budget is marked by the reduction in social security contributions on the side of employers by 5 percentage points, coming into effect as of 1 May 2009 (cost to the budget: 0.4% of GDP). Spending priorities include a differentiated increase in public sector salaries as of 1 May 2009, as well as the introduction of more effective forms of funding of expenses in Higher Education and Secondary Health Care. The targeted deficit in 2009 of 4.2% of GDP is plausible as the government has in the past been able to deliver on deficit targets. However, in light of the above mentioned substantial risks to the revenue projections, sticking to this deficit target may necessitate a supplementary budget in the course of 2009, which could include a substantial reduction in administrative expenditures and, more importantly, a significant reduction in capital spending.

The fiscal strategy for the remaining two years of the programme comprises a continued high level of public investment spending at around 7% of GDP, an average increase of pensions at an annual rate of 12%, a (continued) differentiated increase of public wages and the reduction of the deficit to 3% of GDP. The fiscal consolidation relies somewhat more on increasing revenues than lower expenditures (table 2). The increase in revenues could turn out to be difficult to achieve, at least in the short run. The decrease in spending includes a higher reduction in capital spending than in current spending. Unfortunately, the planned annual increases in pensions are not quantified, neither in terms of their impact on annual budgets over the programme horizon, nor in terms of their impact on the long-run sustainability of public finances.

Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

A fiscal risk mentioned explicitly in the programme is the interest rate risk. Due to the substantial size of the public debt, higher interest rates can rapidly reduce the budgetary room for manoeuvre. The relative importance of this interest rate risk should be quantified in budgetary terms. The exchange rate risk is not mentioned explicitly, but is not negligible either (around one third of the public debt is denominated in foreign currencies). Otherwise, as of 2009, the main risk to the fiscal outlook seems to have shifted from the expenditure side (whereas until 2008 the subsidies to the public energy company were a major concern, in 2009 Albania expects to become a net exporter of electricity) to the revenue side. Lack of consistency of fiscal revenue projections with a realistic macroeconomic outlook constitutes the single most important risk to this year's programme. This risk is partly related to the substantial widening of the external imbalance in 2008, which in case of an abrupt adjustment could entail a significant reduction of domestic demand and imports, dragging down indirect taxes and thus overall public revenues. A discussion of risks with regard to budgetary expenditures is still missing in the programme. Also, the programme is rather opaque with respect to the financing of the substantive and continuous increases in public wages and pensions over the programme horizon.

The evolution of public foreign debt is broadly in line with the previous programme's assumptions. The increase of foreign debt in 2008 was actually lower than foreseen, not the least due to the downward adjustment of the budget deficit in 2008 from a planned 7.9% to 5.2% of GDP. The public debt ratio increased to 54.5% of GDP in 2008 and is forecast to reach 55% of GDP in 2009, before gradually declining to 52.1% in 2011. On the basis of nominal GDP growth and deficit developments alone, the debt ratio could have reached 52% of GDP already in 2008, as 2.5% of GDP are so-called stock-flow-adjustments, mirroring a significant increase in contracted external debt. The refinancing of public debt, a large share of which falls due in 2009, constitutes another important direct risk to the budget. The overall stock of public external debt increased by 340 million euro in 2008 (3.8% of GDP). This type of debt is poised to see another substantial increase of a similar size in 2009, as Albania is seeking external financing for its ambitious public investment programme. As a consequence, the exposure to exchange rate movements is increasing. Under the assumption of the euro/lek exchange rate falling into the range of 126-127 and taking into account the change in the maturity structure of the debt leading to a higher weighted average yield, the EFP foresees debt

service to increase to 3.7% of GDP in 2009 and 2010, before falling slightly to 3.6% in 2011. There is no sensitivity analysis provided in the programme that could quantify budgetary risks surrounding this baseline scenario.

As of April 2008, debt can be incurred as well at the local level of government, but so far no use has been made of this new possibility. The General Debt Department is managing both government securities, representing two thirds of the public debt stock, and contracted debt, which almost exclusively consists of external debt. The yield curve of Albanian securities has performed a parallel upward shift until the end of 2008 in line with growth developments and a maturing business cycle. However, the first round of auctions in 2009 has led to a significant adjustment of yields, with the average yield on three month securities falling just under 6% and the yield on 12-month securities rising to 8.8%. The lower short-term yield could be driven by the reduction of Bank of Albania's benchmark rate to 5.75% in January, whereas the higher medium-term yield could signal an increased risk premium demanded by market participants. At this stage, against the background of a severe international financial crisis, the Albanian government so far has not experienced any difficulties to finance its debt, but 2009 is expected to be a challenging year with a large share of the debt falling due.

Budgetary implications of "major structural reforms"

The programme mentions two major structural reforms: the autonomy of institutions of higher education and the centralisation of the provisioning and financing of health care. Budgetary impacts are limited, the 2009 EFP only mentions an above average increase for operational and maintenance expenses as a result of these reforms.

1.3.2. Quality of public finances

The programme does not explicitly mention revenue or expenditure measures relating to the quality of public finance. However, the government has significantly streamlined its public investment programme by reducing the number of projects while increasing the average size of project by a factor of five. The administration of the small business tax has been successfully decentralized and the rules governing the fiscal revenue sharing scheme have been clarified, increasing the scheme's transparency and efficiency. Rules and procedures of local treasuries have been strengthened and some additional tax authority and the right to incur debt have been transferred to the local level. The structure of public spending is intended to remain growth-enhancing, with a high level of spending on public infrastructure, a low and decreasing level of subsidies, and with improvements in the cost management of the education and the health sector. The broad-based taxes with low rates ensure a low level of economic distortion, and the newly introduced system of reference wages effectively helps to reduce tax evasion and informality. The major challenge to the current programme lies in addressing the risks on the revenue side without being forced into drastic reductions of public investment spending.

1.3.3. Institutional features of public finances

After a new organic budget law was adopted in 2008, with implementation starting in 2009, all budget organisations are presently included in the medium-term budget planning process, which had been initiated in 2001. They thereby participate in the shift from input budgeting to output and performance budgeting. For the time being, there is no explicit fiscal rule in place.

1.4. STRUCTURAL REFORMS

1.4.1. Structural reforms and European Partnership

The programme's comprehensive and coherent framework of structural regulatory reforms continues, as in previous years, to have its focus on the improvement of the business environment as its main objective, including strengthening incentives for the domestic creation of new undertakings and rendering Albania more attractive for FDI. The programme provides detailed information on measures that were recently implemented or are planned within the time horizon of the EFP. As the onus lies on regulatory reform, little quantitative information is available. However, in the case of privatisation, the links to public finances could be made more transparent. Overall, the strategy is largely supportive for the fulfilment of the two economic Copenhagen criteria and bodes well with the country's policy mix. As it is the case with the macro-fiscal framework, the structural reform agenda fully addresses the economic criteria (short-term and medium-term) as described in the European Partnership priorities.

1.4.2. Product and capital markets

The regulatory reform of product and capital market continued on the basis of an unchanged strategy, but with increased speed of implementation. The reform measures adequately address gaps that were identified in the Progress Report. Business registration has been facilitated and the whole area of licensing and permits has been overhauled, resulting in a substantial reduction of the overall number of licences and permits from 166 to 104 and switching their administration from an ex-ante control to a mostly ex-post control mode. The restructuring of the energy sector is making progress, and the (un-bundled) distribution network's privatisation is well advanced. In 2009, privatisation efforts will focus on the production part with the goal to finalise the full privatisation of the electricity sector by 2011. Further privatisations took place, or advanced in their preparations, in the energy and telecom sector.

The financial sector is increasingly fulfilling its role of financial intermediation while remaining robust and well capitalized. Overall credit to the economy reached 36.3% of GDP by the end of the third quarter 2008, a still rather modest level, up by 9.7 percentage points over the last 12 months. Around two thirds of credit is allocated to the business sector. Prudential indicators deteriorated somewhat compared to the same period of the previous year, but remained sound. The programme expects a negative impact on banking activity to come rather via real effects (i.e. via lower activity, trade, etc.) than financial contagion. It nevertheless mentions concerns that restrictive financing terms by parent-banks, increased safety provisions and an increase in non-performing loans could weigh on the overall costs of financial intermediation. If this were the case, real activity would be negatively affected which could result in a further negative feedback-loop.

During 2008, several new regulations came into force, addressing the calculation, surveillance and reporting of risk exposures of banks, clarifying the competences of the supervisory authority and strengthening internal control systems, as well as increasing the transparency of banking products vis-à-vis their clients and their shareholders. The Bank of Albania continues to monitor closely the evolution of un-hedged position of loan takers, as well as the situation of financial institutions with highly concentrated exposure to specific markets and/or financial products.

In 2009, further regulatory reform will implement parts of Basel II, sharpen legal provisions for bank rescue and liquidation, review capital requirements for banks and further instruct banks how to deal with currency mis-match and interest rate risk. As last year, the programme mentions ongoing work towards the full liberalisation of the capital account to be completed by 2012. The programme's reform agenda in the area of capital markets appears fully adequate and sufficiently comprehensive and ambitious, and it supports well the policy-mix targeted by the Albanian authorities.

1.4.3. Labour market

Albania continues to implement the National Strategy of Employment and Vocational Training adopted in late 2007 which includes numerical objectives for various labour market indicators. This strategy is largely in line with European Partnership priorities. A number of ongoing and planned measures aim to reduce the mis-match between labour supply and demand, including initiatives for training on the job, financial incentives for job creation and vocational training, the latter also with a special focus on women, ethnic minorities and young persons. In 2008, 43% of unemployed were female and 27% of unemployed were under 25 years old. Budgetary costs of these initiatives seem to be very low, which also applies to passive employment policy measures. Unemployment allowances were increased by 14.2% in 2008, but the actual number of recipients remains very small, partly due to tight eligibility criteria. The EFP foresees unemployment to fall from 12.3% in 2009 to 10.2% in 2011 on the back of steady employment growth, leaving the participation rate largely unchanged. The further labour market reform agenda is marked by the approximation of EU practices in the areas of health, insurance and safety at the workplace, including the regulatory framework of work inspections.

Basic social assistance is due to increase rapidly over the programme period, but its budgetary impact remains very limited, reaching 0.4% of GDP in 2010. Assistance to disabled persons is strongly increased as well. The policy on pensions aims to bring pensions of persons living in rural areas up the level of those living in urban areas by 2012. As of July 2008, urban pensions were increased by 10%, rural pensions by 15%. The EFP mentions that the 2008 increase is financed from the contingency fund in the 2008 budget, whereas the 2009 budget has integrated the pension obligations under the heading of social security spending. The programme mentions that the continued increase in pensions is financed by the increased payments of social contributions by business, including arrears. Effective minimum wages in the public sector have reached EUR 200 in 2008; legal minima for salaries economy-wide are expected to reach the equivalent of EUR 160 in 2009. The EFP underlines that the existence of legal minimum wages so far did not impact negatively on business activity. The various policy measures in the area of social assistance, pensions and wages do not seem to endanger fiscal sustainability. Nevertheless, a more detailed analysis of how the pensions impact on the budget should be included in the EFP.

1.4.4. Other reform areas

Albania continues to implement a host of measures under the heading of public administration reform. This includes functional reviews and training initiatives to address skills gaps in the public sector. Re-organisation goes hand in hand with a reform of the wage scheme in the public sector with the apparent goal to increase wage spreads in order to better reflect demand for specific skills. While this is certainly an adequate initiative with a view to enhance productivity in the public sector, the EFP only provides information on growth rates for different wage groups without specifying its budgetary impacts. This is regrettable and should be corrected in the future. Also, the potential role of these differentiated wage increases in terms of setting the scene for wage negotiations in the private sector should be monitored closely. In this respect, it seems advisable that the government's wage strategy is designed and implemented in due consideration of the central bank's inflation target in order not to impair the overall policy-mix.

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2. BOSNIA AND HERZEGOVINA

SUMMARY AND CONCLUSIONS

- In January 2009, Bosnia and Herzegovina (BiH) submitted to the European Commission its 2009 Economic and Fiscal Programme (2009 EFP) covering the period 2009-2011. The programme aims at achieving strong economic growth and consolidating public finances, including a significant reduction of the share of the general government budget in GDP, which is a welcome objective. The programme broadly complies with the content and form required, but the data provided is often scarce. In general, the means to achieve the objectives of the programme are not adequately explained or quantified.
- The 2009 EFP estimates real GDP growth to have been at 5.6% in 2008, below the 6.8% recorded in 2007. Economic growth is expected to slightly speed up in 2009 (5.7%) and 2010 (6.1%). Domestic demand is foreseen to remain the main driver of growth, supported by a small positive contribution of net exports in 2009. The growth scenario seems overly optimistic throughout the whole programme horizon because it assumes that the BiH economy will be largely spared by the global economic downturn. This also leads to a rather high projection of inflation. The macroeconomic scenario fails to include external sector projections. However, external imbalances can be expected to remain high, though falling in the context of the current crisis. Restrictive fiscal policies are crucial in order to support the much needed adjustment process.
- The public finance scenario gives an overview of the country's fiscal targets for 2009-2011 and of the improvement of fiscal coordination achieved through the establishment of the National Fiscal Council. The document presents a consolidated fiscal framework for the whole country as well as for the state level and the entities, which enhances its comprehensiveness compared to the previous programme. The projected path of fiscal consolidation in 2009 and beyond is broadly consistent with the presented macroeconomic framework, as diminishing prospects for privatisation and rising costs for financing highly constrain the financing of fiscal deficits. However, it seems unrealistic given the dampening effects of the global economic crisis on internal demand and imports, both significantly reducing revenues. In addition, the envisaged bold reduction in public spending as a share of GDP is not backed by concrete plans and key measures on the revenue and expenditure side are not always sufficiently explained and quantified. The envisaged improvement in the quality of public finances is mainly focused on procedural issues and lacks a discussion of other dimensions like the size and efficiency of the public sector and the level and sustainability of fiscal positions.
- The structural reform agenda is in general supportive for the fulfilment of the Copenhagen economic criteria and broadly follows the findings of the Progress Report, though it does not seem sufficiently ambitious. More emphasis on the necessary improvement of the business environment and attracting foreign direct investment would have been beneficial. The programme hardly provides any quantitative estimates of the effects of the envisaged reform measures.
- Main risks related to the 2009 EFP stem from the uncertainty about the possible effects of the unwinding of the global economic crisis on Bosnia and Herzegovina which may severely change the macroeconomic scenario and especially budget revenue assumptions.
- The programme's reform agenda is broadly consistent with the fiscal scenario and generally aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership. The overall policy response of the 2009 EFP to the international economic and financial crisis, however, is not sufficient.

2.1. INTRODUCTION

In July 2006, the Commission invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia for the first time to submit by 1 December an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. The scope and content of the EFP are similar to the Pre-accession Economic Programmes (PEPs) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

The 2009 EFP of Bosnia and Herzegovina covers the period 2009-2011 and was submitted to the Commission on 15 January 2009, well within the requested deadline. The programme was adopted by the Council of Ministers of BiH, being regarded as a key document on the path towards European integration. It is, however, not well integrated into the budgetary procedures and its use as a policy making tool could be improved. The Editorial Board consisted of representatives from the Ministry of Finance and Treasury of BiH, the Directorates for Economic Planning and European Integration and the Ministries of Finance of the Federation of Bosnia and Herzegovina (Federation) and the Republika Srpska.

The programme broadly complies in terms of content, form and data with the requirements stated in the outline, although further improvements could be made. The recent macroeconomic performance is adequately described. The general objectives could be more clearly elaborated and adequately backed by concrete policy measures, whose economic or fiscal impacts could have been quantified to a larger extent. Some of the tables were not filled in properly. The assumptions underlying the medium-term macroeconomic scenario were already outdated by the time of drafting the EFP and do not properly take into account the likely impact of the global economic crisis on BiH. The main findings of the Commission's assessment of the economic Copenhagen criteria in the last Progress Report are quoted but the link to the EFP itself and measures described therein is not always clear.

2.2. ECONOMIC OUTLOOK

2.2.1. Recent macroeconomic developments

The programme extensively describes macroeconomic developments in 2007, when real GDP growth stood at 6.8% (following the production approach) or 12.1% (expenditure approach). Main drivers of growth were private domestic consumption and investments. Economic activity grew strongly in sectors such as construction, manufacturing and financial services. Little factual evidence is provided for 2008 when growth stood at 5.6% according to the programme. According to the statistical institutes of the two entities, growth of industrial production in the Republika Srpska accelerated sharply from 1.4% in 2007 to 16.8% in 2008, and slightly fell from 8.6% to 7.9% in the Federation.

The illustration of recent economic developments could have been more concise and would have benefitted from a wider use of data available at the time of submission. The depicted macroeconomic scenario seems overly optimistic when taking into account likely impacts of the global economic crisis.

Table II.2.1:
Macroeconomic developments

	2007	2008	2009	2010
Real GDP (% change)	12.1	5.6	5.7	6.1
<i>Contributions:</i>				
- Final domestic demand	13.3	8.5	5.9	6.0
- Change in inventories	2.5	-0.2	-1.4	0.2
- External balance of goods and services	-3.7	-2.6	1.2	-0.1
Employment (% change)	4.8	4.8	4.7	4.7
Unemployment rate (%)	29.0	23.4	25.4	27.3
GDP deflator (% change)	1.9	8.1	4.7	4.9
CPI inflation (%)	1.5	8.3	5.5	4.5
Current account balance (% of GDP)	-12.6	n.a	n.a	n.a

Source: EFP 2009 submission

Box II.2.1: The global financial crisis: First impact and policy response

The global economic slowdown has started to impact on BiH. The metal and automotive industries, the country's most important export sectors, have recently announced output cuts and lay-offs. Trade dynamics have dramatically slowed down in early 2009. In general, sectors such as construction, manufacturing and trade which have been identified in the 2009 EFP as the ones that would contribute most to growth are suffering severely. Public revenues have dropped in early 2009, compared to the previous year.

In October 2008, tensions in the financial market led to a withdrawal of deposits by the population and liquidity shortages in the banking system. The annual growth of broad money (M2) fell sharply from around 22% at the end of 2007 to only 3.2% in November 2008 and further to 2.6% in January 2009, mainly due to a slowdown in the growth of demand deposits which turned even negative in the last quarter 2008. Credit growth slowed to 20.3% in January 2009, down by 9.5 percentage points since the middle of 2008, and became negative in monthly terms. Profitability indicators of the banking system such as return on assets and equity declined significantly in 2008. In order to strengthen and restore confidence in national financial markets and to stimulate credit activities the Central Bank of Bosnia and Herzegovina (CBBH) provided liquidity to the banking system and lowered the minimum reserve requirement rate from 18% to 14% in October. Furthermore, as of November all new credit lines from abroad by commercial banks do not enter into the basis for required reserves calculation and, as of January 2009, the required reserve rate on term deposits with a remaining maturity of more than one year is further lowered to 10%. Even though the CBBH reacted well, there seems to be room for improvement of its crisis preparedness. The government initiated an increase of the deposit guarantee from around EUR 3,500 to more than EUR 10,000.

The EFP lists some possible negative effects on BiH if the global crisis were to last long. However, it does not elaborate on their magnitude and concludes that the crisis is expected to only have some short-term effects in the last quarter 2008 and the first quarter 2009, but not to have a significant impact on BiH over the medium-term. The National Fiscal Council intended to adopt a restrictive fiscal policy at all state levels aiming at a growth rate of public spending that would be lower than (nominal) economic growth expected at that time. This was translated into the Council's provisions to limit the increase of the size of the budget at state level to 12% and at the entity level at 6%. Unfortunately, the base to which this increase is compared is not commonly interpreted. Given the optimistic growth projections the intention of the Fiscal Council will probably not materialise into the planned reduction of the spending-to-GDP ratio and it seems to be necessary to adopt new fiscal targets, reflecting realistic GDP and revenue projections. In addition, budgetary achievements may not meet the ambitious targets. The programme does not include any other policy measure that explicitly responds to the global economic crisis.

2.2.2. Medium-term macroeconomic scenario

While it is acknowledged that under present circumstances it is extremely difficult to present a medium-term macroeconomic scenario, it needs to be stated that some of the information underlying the external assumptions of the scenario presented in the 2009 EFP was already outdated at the time of submission. In fact, the Commission's 2008 spring forecast was used when the autumn forecast had already been available.

The medium-term macroeconomic scenario is not convincingly presented in the 2009 EFP. The relevant section focuses mainly on past developments rather than elaborating on forward-looking perspectives. The EU and world growth assumptions used in the programme are highly optimistic; so is the key internal assumption that the global crisis will not significantly affect the country's economy. Oil prices are projected at a relatively high level. The programme's main objective of consolidating public finances directly depends on these assumptions as the main source of public revenues stems from indirect taxes. Already under given assumptions a slower rise of revenues from indirect taxes is expected. Taking into account the ongoing fall of import prices, revenue assumptions become unrealistic. Actual revenue developments in early 2009 further strongly support this scepticism. A whole set of reform areas is widely discussed, unfortunately without a comprehensive analysis of their fiscal impacts. The discussion of main risks to the macroeconomic scenario is limited to some thoughts about the possible length of the global financial crisis and does not adequately reflect nor quantify the impact of possible demand or supply shocks.

Real sector

The 2009 EFP is based on a scenario of robust economic activity. Real GDP growth is expected to remain strong in 2008, though falling to 5.6% from 6.8% in 2007. For 2009 and 2010 real growth is projected to pick up to 5.7% and 6.1%, respectively, before reaching 5.7% in 2011. Domestic demand is expected to remain the main driver of growth, backed by a positive contribution of net exports in 2009. Gross fixed capital formation declines from its high 2007 level but remains above the GDP's real rate of change, which is not consistent with the investment levels presented in table 1a. The gross value added generated in agriculture rebounds in 2008 and its growth remains around 5% annually 2009-2011. In the industrial sector this growth is projected to accelerate to 10.2% in 2009 from 7.6% in 2008, and afterwards fall to 8.9% in 2010 and 7.6% in 2011, while in the services sector it remains between 5.4% and 5.8% over 2009-2011. Employment growth is expected to remain stable at 4.6%-4.8% during the programme period, while the unemployment rate would drop significantly. Annual

labour productivity growth is projected to increase steadily from 14.5% in 2008 to 18.3% in 2011, remaining above wage growth rates. However, this increase in labour productivity represents a significant rise compared to the projections presented in the previous year's EFP and appears unrealistic in relation to the projected increases in real GDP and employment.

Some confusion is caused by the strong deviations of expenditure and production side approaches applied to the base year 2007. Furthermore, the descriptive part of the programme is almost exclusively backward looking, and the explanations to the growth scenario presented in the annexed tables are missing. The programme's economic growth projections on the EU and international environment are very optimistic when compared to estimates of the Commission or International Financial Institutions. The use of the Commission's 2008 autumn forecast as underlying assumption instead of the spring forecast would have probably resulted in a slightly different growth scenario, but even that would have been on the optimistic side given the fact that the Commission strongly revised downwards its forecast in January (admittedly, after the date of submission of the programme). In this context, expected labour market improvements may also prove to be too optimistic, being in line with recent years' developments. The impact of the global economic crisis would additionally materialise in a need for reallocation of capital and labour within the production structure, thus pushing up unemployment. Finally, the growth of labour productivity appears to be overestimated.

Inflation

Inflation is projected to remain above euro area levels, decreasing however from its 2008 level of 8.3% to 5.5% in 2009 and further to 4.5% in 2010 and 3.7% in 2011 (table 1) due to the expected stabilisation of international oil and food prices, and given the high share of internationally determined food and energy prices in the consumer basket. While overall this is a plausible scenario, possible domestic drivers of inflation, such as the high wage increases especially in the public sector, the fiscal relaxation pursued in recent years and continued high, though falling, credit growth, could also have been examined. Nevertheless, given the assumptions on international oil price developments and the evolution of inflation in early 2009, projected inflation rates will prove to be too high.

Monetary and exchange rate policy

As the nominal exchange rate is fixed against the euro, the evolution of the real exchange rate is determined by the inflation differential vis-à-vis the euro area. By projecting higher inflation, the programme implicitly assumes an appreciation of the real exchange rate against the euro.

External sector

As in previous years, forward-looking estimates of the external balances are not provided. The 2009 EFP even falls behind the vague improvements of the previous programme, as no projections of the current account development and its financing are presented.

The current account deficit stood at 12.7% of GDP in 2007, mainly financed by high FDI inflows, which were particularly high as a result from a major privatisation deal in the Republika Srpska. The information provided on 2008 export and import levels is not consistent throughout the document. The growth rates of exports of goods and services in 2008 of 7.5% and of imports of 8.2% as presented in the annexed table of macroeconomic prospects are lower than what is suggested by available trade data. While in 2008 import growth remained above export growth, this picture is set to change in the EFP from 2009 onwards – strongly supported by trade data from the beginning of the year – implying an improvement in the current account if the terms of trade do not deteriorate in the process. Given price developments of Bosnia and Herzegovina's main import goods and decreasing internal demand, the latter seems to be a realistic assumption. However, the faltering external demand due to the crisis makes the projection of 9.1% export growth in 2009 above the 7.5% growth recorded

in 2008 unrealistic. The EFP would have benefitted from an analysis of the development of financial and capital accounts, on which only scarce information is provided. External imbalances will remain relatively high, so the necessary adjustment will have to be driven by restrictive fiscal policies, in particular as capital inflows are adversely affected in the context of the crisis and FDI, portfolio investments and foreign borrowing are declining.

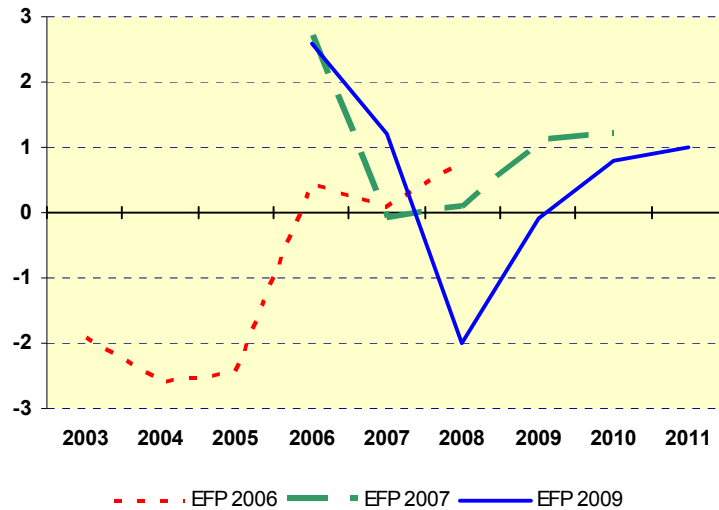
Main risks to the macroeconomic scenario

The discussion of main risks to the macroeconomic scenario is limited to some thoughts about the possible length of the global crisis. It does not adequately reflect nor quantify the impact of possible demand or supply shocks. The programme envisages a relatively positive scenario both for developments at global and EU level and for the domestic economy. However, risks are high that the slowdown will be deeper and longer and external financing constraints will affect the economy. The current growth model based on high credit growth and external financing fuelling into high consumption and investment may prove not to be sustainable. Moreover, falling import prices and the slowdown of economic activity put the authorities' revenue assumptions at high risk. A possible slowdown in current transfers due to labour market developments in host countries of Bosnian emigrants would have major effects on the country's disposable income, private consumption and output growth.

2.3. PUBLIC FINANCE

As in the previous programme, the 2009 EFP presents a consolidated fiscal framework for BiH, which is this time accompanied by those of state institutions, the Federation, the Republika Srpska and Brčko District. The presentation of fiscal scenarios for each of them increases the transparency and comprehensiveness of the budgetary overview but the use of the countrywide GDP as deflator instead of the individual ones blurs somewhat real fiscal developments at the entity level. The fiscal objectives of the programme are linked to the European Partnership priorities and the findings of the Progress Report, but their achievement is questionable given the insufficient explanation of the implementation policies, the missing quantification of fiscal measures and protracted structural reforms. In addition, the past track record does not provide grounds for unwarranted optimism. The loosening of fiscal policy experienced in recent years during good times raises doubts on the credibility of the envisaged fiscal tightening in times of economic slowdown. The presentation of fiscal risks could have been more straightforward and better quantified. Data were processed in compliance with the GFS 2001 accounting standards, representing a good starting point for the transition to ESA 95.

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



The fiscal part of the 2009 EFP envisages a gradual reduction of the share of revenue to GDP by 4.2 percentage points and of expenditures to GDP by 7.2 percentage points during 2008-2011. The expected consolidated budget deficit of 2% of GDP in 2008 is projected to turn into a surplus of 1% of GDP in 2011. The consolidation path for the period 2008-2010 is much more pronounced in the current programme (2.8% of GDP until 2010) than it was in the previous one (1.1% of GDP).

2.3.1. General government balances and debt

Actual balances and medium-term perspectives

The likely outcome for the consolidated budget in 2008 of a deficit of 2% of GDP as presented in the 2009 EFP deviates substantially from the previous programme's budgetary target of a small surplus of 0.1% of GDP. This deterioration of public finances is mainly due to increased current spending, especially on wages and social welfare. While revenues only increased by 5.7% in the first three quarters of 2008 compared to the same period of the previous year, expenditures increased by 27.8%. Budget execution for this period also shows that expenditures for social transfers and public sector wages increased significantly. The increase of the public sector wage bill was high in both entities, particularly in the Republika Srpska where it reached a sky-rocketing 43.5% compared to 19.8% in the Federation, while social benefits increased by around 31% year-on-year in both entities during the first three quarters of 2008. The programme seems to underestimate the consolidated budget deficit.

The approved 2009 budgets on the state and entity levels suggest a consolidated balance of around -0.5% of GDP, which is below the -0.1% of GDP deficit as outlined in the 2009 EFP, which itself falls way below the projected 1.1% of GDP surplus in the previous EFP. Given the deteriorating economic environment, however, the actual outcome might disclose an even higher deficit this year, if no corrective measures are taken. In March 2009, the government of the Federation announced that it would use two sources to finance its 2008 budget deficit of around EUR 133 million: a loan from domestic banks and drawings from the succession funds of former Yugoslavia's assets. It also decided to rebalance the 2009 budget, a step not considered necessary so far by the Republika Srpska.

The programme is vague about the path of fiscal policies in 2010 and 2011. The envisaged decline in the share of revenues to GDP from 38.8% in 2008 to 34.6% in 2011 is to be achieved mainly through a reduction of the share of indirect taxes and social contributions. The former is associated with a lower collection of import taxes due to international price developments and the implementation of the Interim Agreement following the signature of the Stabilisation and Association Agreement in June 2008. The explanation of the latter remains ambiguous as on the one hand projected increased employment will lead to higher revenues from contributions, and on the other hand, the introduction of pension system reforms in both entities may reduce them. Corporate and income tax reforms in the Federation are expected to have a neutral effect on budget revenues. Finally, measures to improve the efficiency of the tax collection system are envisaged or have already been implemented at all state levels. The reduction in the share of expenditures to GDP from 40.8% in 2008 to 33.6% in 2011 concerns both current and capital spending, but the necessary measures are hardly explained. The programme states that the Republika Srpska government has announced the possibility of reducing salaries in the public administration by 10%. While this would only be a small countermovement to the extraordinarily high wage increases in recent years, it would certainly be a positive step towards fiscal prudence. Apart from this possibility, the programme does not describe any concrete measures to reduce public spending over the coming years.

The programme plans a fiscal consolidation of around 3% of GDP for the period 2008-2011, but it fails to analyse fiscal risks and to reveal how to achieve this quite ambitious objective. The increase of taxes is not an option, given the already high revenue-to-GDP ratio, and it would adversely impact the medium-term growth prospects of Bosnia and Herzegovina. High risks stem especially from lower than expected revenues from indirect taxes and customs. Risks are particularly high in the Federation as it cannot revert to deposits stemming from the privatisation process like the Republika Srpska whose privatisation receipts accumulated in recent years to some extent may cushion the negative effects of the crisis on the budget. Furthermore, risks are related to lower privatisation proceeds, liabilities related to the deposit insurance and to social spending and the settlement of domestic claims related to foreign exchange deposits that were frozen under the former Yugoslav federation.

Table II.2.2:
Budgetary adjustment (% of GDP)

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	40.7	38.8	38.1	36.2	34.6	-4.2
<i>of which:</i>						
- Taxes and social security contributions	34.9	33.3	32.6	31.1	29.9	-3.4
- Other (residual)	5.8	5.5	5.5	5.1	4.7	-0.8
Expenditure	39.5	40.8	38.2	35.5	33.6	-7.2
<i>of which:</i>						
- Primary expenditure	39.0	39.8	37.1	34.5	32.7	-7.1
<i>of which:</i>						
Gross fixed capital formation	3.1	4.3	3.3	2.8	2.9	-1.4
Consumption	19.7	18.7	18.6	17.3	16.1	-2.6
Transfers & subsidies	14.1	13.9	12.8	11.9	11.4	-2.5
Other (residual, incl. consumption)	2.3	2.9	2.5	2.4	2.3	-0.6
- Interest payments	0.5	1.0	1.1	1.0	0.9	-0.1
Budget balance	1.2	-2.0	-0.1	0.7	1.0	3.0
Primary balance	1.7	-1.0	1.0	1.7	1.9	2.9
Gross debt level	8.4	n.a.	n.a.	n.a.	n.a.	n.a.

Sources: EFP 2009 submission, ECFIN calculations

Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

The 2009 EFP does not provide any projections for the evolution of gross public debt. The stock of external public debt of Bosnia and Herzegovina is relatively low (around 15% of GDP at the end of 2008) and has been declining in recent years (21.3% of GDP in 2006 and 18.3% of GDP in 2007). In addition, a large part of the debt stock was contracted on concessional terms, which explains the

relatively low cost of external debt servicing of below 1% of GDP per year, which is projected to rise slightly above 1% of GDP in 2009-2011. The World Bank is the largest creditor, accounting for more than half of the outstanding debt stock. Around 90% of the debt is denominated in either euro or US-dollar, with an increasing share of euro-denominated debt. The maturity structure is quite favourable, as there is no official short-term foreign debt. Risks are associated with currency movements, especially in the USD exchange rate, and a variation of interest rates as slightly more than half of the debt stock has been contracted with variable rates. A prudent stance is being facilitated by the adoption of debt laws in the Federation, Republika Srpska and at state-level which limit government borrowing by introducing sub-ceilings on the level of debt service relative to current revenue in the preceding year. Internal debt is managed by the entities. Its level is estimated at around 14% of the 2007 nominal GDP. However, high uncertainties remain concerning the validity of this figure, especially taking into account the increasing number of applications lodged to the Court of Human Rights in Strasbourg. A settlement of outstanding domestic claims remains one of the most important fiscal challenges in the near future. The programme projects relatively stable interest expenditures connected to internal debt at around 0.6-0.7% of GDP from 2009 to 2011.

Information on below-the-line operations and stock-flow adjustments is not provided (table 4 in annex 2 is practically empty) and therefore cannot be assessed.

Budgetary implications of "major structural reforms"

The programme does not provide a clear picture of the impact of structural reforms on the country's fiscal position. The matrix of policy commitments (annex 3) was not provided and important structural measures in the field of taxation, privatisation or enterprise restructuring are neither properly described nor quantified. For example, the budgetary impact in the Federation of the 2009 reforms of personal income and corporate profit taxation or those of the pension system reforms in the Republika Srpska should have been more thoroughly assessed.

2.3.2. Quality of public finances

The programme describes some initiatives that are aimed at improving the procedures of budgetary planning and execution as well as of the management of public finances, including the establishment of the National Fiscal Council (see following section). While these initiatives are certainly welcome, the 2009 EFP remains vague on the extent to which some of these procedures have already been implemented and does not provide detailed explanation on how they contribute to a better quality of public finances and to the general goal of reducing the share of public spending in GDP. Besides, it fails to explain actions needed as a follow up to audit reports' findings.

However, there are more dimensions to the quality of public finances such as the size of the public sector, the sustainability of public finances or the composition and efficiency of revenue and expenditure systems. While an improved composition of public spending, where more resources are allocated for capital investments and less for government consumption and social transfers was one of the main objectives of the previous EFP, it does not figure prominently in the current one. Nevertheless, this issue has not lost its relevance because together with the projected reduction in the relatively high share of public spending in GDP – which is probably even underestimated in the programme because it is based on the expenditure side estimates of GDP which are still in an experimental stage and significantly above the production side estimates – it should provide more space for the development of private sector activities and enhance the growth potential of the economy. Adopted 2009 budgets, however, rather point in the opposite direction by disclosing a reduction only of capital expenditures, while current expenditures are still on the rise. According to the EFP, after a peak of 10.5% in the share of capital investments in overall public spending in 2008, this relation falls again to 8.6% in 2009, and further to 7.9% in 2010. Furthermore, while the topic remains a major challenge in the country, the efficient use of resources in the public sector is not

adequately addressed in the programme. The public sector wage bill rose again fast in 2008, while social transfers are relatively high: They are projected to remain stable between 29% and 30% of total spending in the period 2008-2011. Besides, the components which are means-tested for poverty reduction are crowded out by the war veterans' benefits. The significant differences between the levels and dynamics of officially registered and survey-based labour data point to the existence of a fairly large and growing informal labour market, caused inter alia by a high labour tax wedge. The taxation reforms in both entities may contribute positively to the alleviation of this problem, but evidence is scarce and not provided in the programme.

2.3.3. Institutional features of public finances

The fiscal architecture of Bosnia and Herzegovina derives from the structures created by the Dayton/Paris Peace Agreement. Direct taxation is under the competence of the two entities and the autonomous Brčko District, while the 14 cantons of the Federation also enjoy a large fiscal autonomy. Indirect taxation was harmonised across the country and a common value added tax (VAT) was introduced on 1 January 2006, contributing to the creation of a single economic space. Indirect tax revenues are pooled in a common single account.

The adoption of the Law on the National Fiscal Council and its establishment in September 2008 are very important achievements strengthening the necessary fiscal coordination within the country, since fiscal decentralisation in the context of sharing a single currency carries the risk of a free-rider behaviour with potentially destabilising effects for the currency board arrangement. So far, the Fiscal Council has played a positive role in setting ceilings for the 2009 budgets on state and entity level and it seems to have the necessary back-up in the decision-making political bodies. However, in the absence of agreed deadlock breaking mechanisms it may become more difficult for the Fiscal Council to agree on expenditure cuts that may need to be introduced shortly. The institutional cooperation in the Council could further address issues related to the adoption of fiscal rules that would cap the growth of public spending at the different state levels and agree on common standards for a transparent budgeting process.

2.4. STRUCTURAL REFORMS

The 2009 EFP comprises more structural reform areas than the previous one, namely the enterprise and financial sectors, labour market, public administration, the pension systems, health care, education and transport. The presentation is very extensive but largely descriptive and the agenda is vague on the overall strategy in certain areas as well as on their link to the programme's fiscal objectives. In most instances, the reform plans are not backed by concrete measures, commitments or timetables for achieving the policy objectives and their effects are not quantitatively estimated. The relation between the structural reform agenda and the fiscal strategy is hardly elaborated and annex 3 containing the matrix of policy commitments was not provided.

In general, the reform strategy is supportive to the fulfilment of the Copenhagen economic criteria and broadly follows the findings of the Progress Report. Nonetheless, it does not seem ambitious enough, in particular given the large backlog of reforms in the enterprise privatisation and restructuring in the Federation. An increased focus on the improvement of the business environment and attracting foreign investment would have been necessary. More concrete objectives and timetables for the acceleration of the privatisation process, restructuring and the liquidation of loss-making enterprises, in particular in the Federation, would have been welcome. In a similar vein, the reform commitments to reduce structural rigidities on the labour market appear to play only a secondary role on the reform agenda.

2.4.1. Structural reforms and European partnerships

The programme reveals a rising awareness of policy makers in the country about some of the reform areas that are highlighted in the European Partnership. Positive examples are the establishment of the National Fiscal Council and the envisaged reduction of public spending relative to GDP, as foreseen by the programme. It further addresses economic priorities such as the improvement of the quality of public finances, the privatisation process, and the issue of labour mobility or the reform of the pension system.

2.4.2. Product and capital markets

With regards to the real economy, the programme focuses on enterprise privatisation and restructuring. Measures concerning the strengthening of corporate governance and state aid control or SME development are not provided, unlike in the previous programme. The presentation of the privatisation process is less detailed compared to the previous programme in the case of the Federation, while the opposite holds for the Republika Srpska. This somehow reflects the state of the process which is more advanced and ambitious in the Republika Srpska than in the Federation. A concise overview of the amount of capital privatised so far, including clear commitments for the remaining capital and the envisaged timetable to finalise the process is missing for both entities. Equally important, the restructuring of state-owned enterprises is hardly mentioned. While the liquidation of state-owned loss-making companies is mentioned in the context of the general government balance, it is not reflected in the part dealing with privatisation and structural reforms. The programme fails to outline the reform plans in the utilities and network industries, albeit the strong need for further reforms in these sectors.

Concerning financial markets, the programme describes the crisis response measures taken by the Central Bank during the last quarter 2008 (see box 1 of this assessment), which had liquidity-smoothing and confidence-enhancing effects, at least in the short-term. It furthermore points out to the adoption of the laws on the securities market, on investment funds and on leasing in the Federation which aim at further developing the financial market. They entered into force in January 2009. In the Republika Srpska meanwhile, the establishment of a financial sector supervisory committee is envisaged in order to better coordinate the activities of the existing agencies that supervise different market segments. The respective law was adopted in February 2009. An assessment of how risks have been managed during the ongoing financial crisis and whether or not the current set-up is still adequate would have been very useful. Furthermore, the stability situation of the Bosnian financial sector could have been more extensively explored.

2.4.3. Labour market

The programme focuses on ongoing active labour market policies which are mainly related to co-financing job-creation activities, acknowledging at the same time their limited scope and impact. The persistently very high, though slightly falling, rate of registered unemployment of 42% (third quarter 2008), the low activity rate and the weak labour market dynamics result primarily from structural rigidities related to the taxation of labour, relatively large and poorly targeted social transfers and the rigid wage-setting mechanisms. Consequently, it would have been useful if the programme had assessed the labour market impact of the personal income tax reform in the Republika Srpska in 2007 and the Federation in 2009.

2.4.4. Other reform areas

The 2009 EFP highlights five other reform areas, namely reforms in public administration, the pension system, health care, education, and transport. The reform of the public administration plays an important role in improving the fiscal efficiency of the public sector and creating the structures

capable of adopting and implementing the *acquis* in Bosnia and Herzegovina. The programme describes the progress made in the implementation of the Public Administration Reform (PAR) strategy and the preparation of the second Action Plan. Besides the general objectives of these actions, a more detailed description of the specific areas to be improved and of the results achieved so far would have been welcome.

The programme acknowledges the increasing importance of a pension system reform, given demographic developments in Bosnia and Herzegovina which put under pressure the sustainability of the current pay-as-you-go systems. Policy makers in both entities are working on pension system reforms, but their approaches differ. In the Federation reforms are foreseen to divide the first compulsory pillar into two parts, one financed by contributions and the other one by the budget. An assessment of the budgetary impacts of such a reform would have been useful. The road taken by the Republika Srpska seems more promising as it will introduce a second capital-based pillar and a third pillar of voluntary pension funds to which contributions can be made from the personal income. The respective law establishing this third pillar was adopted in February 2009, while the completion of the whole pension reform in the Republika Srpska is expected by mid-2009. However, concerns are raised in the programme about the recently witnessed loss of confidence in financial markets among the population in the context of the financial crisis, which may make additional efforts necessary to further deepen the financial sector and to safeguard its stability.

The 2009 EFP is very extensive on health care reforms which are planned to be subsidised from the budget (VAT and excise duties) in the Federation, while in the Republika Srpska the contracting of (some) health care services from the private sector is envisaged. Overall, the information given in the programme on the financing of the reforms and about possible budgetary impacts, which would be especially relevant in the case of the Federation, is scarce. Some reform measures in the area of education, including the establishment of three new agencies at state level, and transport are described.

* * *

3. MONTENEGRO

SUMMARY AND CONCLUSIONS

- In January 2009, Montenegro submitted to the European Commission its third Economic and Fiscal Programme ("2009 EFP") covering the period 2008-2011. The programme aims at maintaining fiscal discipline and the budget deficit below 2.4% of GDP in 2009 despite sizeable measures planned to mitigate the impact of the crisis. The authorities' commitment to fiscal discipline is welcome. On the other hand, the contribution of public finances to economic growth may deteriorate given large increases in current spending in the recent past and the likely cutback on capital spending if revenues underperform in the economic downturn.
- The programme estimates real GDP growth at 8% in 2008, below the 10.7% recorded in 2007. The current account deficit continued to rise to around 30% of GDP despite the global crisis, on the back of strong inflows of net FDI. Exports declined by around 20% from 2007 and industrial output stagnated based on the weak performance of the metal sector. The original baseline scenario, a close extrapolation of 2008 early trends, assumed strong growth rates for real GDP. As the unfolding of the global crisis accelerated, the authorities switched to two other, more pessimistic scenarios – a baseline or so-called "real" scenario assuming a growth rate of 5% in 2009 and a "crisis" scenario assuming a growth rate of 2.5% in 2009, 3.5% in 2010 and 4.5% in 2011. While this "crisis" scenario appears more realistic given recent developments, it may not yet fully incorporate the full magnitude of adjustments likely to come.
- The fiscal performance in 2008 was better than originally planned and the budget execution yielded a surplus of around 1.5% of GDP. The improvement was mainly due to over-performing revenues while spending also increased though to a lesser extent. The programme's fiscal framework is flexible as it includes two alternative and more negative scenarios. In case these may also prove to be too optimistic, the authorities are committed to maintaining the budget deficit below the limit of 2.4% of GDP in 2009 by further reducing expenditures. The planned measures on the revenue and expenditure side are adequately described, as well as the fiscal risks. The fiscal policy foresees a fiscal relaxation of around 4% of GDP in 2009, mainly resulting from the revenue slowdown in the crisis and the additional cost of measures adopted to combat it. As the impact of the crisis peters out and the economy recovers, the authorities plan to reduce the deficit to 1.6% of GDP in 2010 and 0.7% of GDP in 2011. Like previous submissions, the 2009 EFP also targets a reduction of the tax burden to citizens and businesses, and of public spending in general.
- The structural reform agenda is widely supportive to the fulfilment of the Copenhagen economic criteria and generally follows the findings of the Commission's Progress Report. There is a clear commitment of the authorities to growth-enhancing reforms that are linked to the accession process. The main objective of the reform agenda is the creation of a more flexible and competitive business environment, thereby increasing productivity and making the country more attractive for investors. However, the EFP still does not elaborate on the interaction and integration of the different policies into an overall strategy for economic development.
- The programme appears to take into account the most relevant risks surrounding economic activity in 2009 and 2010. They are classified in three groups pertaining to the real, fiscal, and financial sectors. The most important ones stem from the uncertainty regarding the unfolding of the global crisis and its potential effects on FDI, tourism, aluminium production and banking activities in Montenegro. Downside risks to the forecast also include a more prolonged crisis with a delayed recovery, thus also putting into question the main assumptions of the programme for 2010-2011.

- The programme's reform agenda is well integrated into the fiscal scenario and largely aligned with the reform requirements of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership. The composition of the policy response to the financial crisis appears broadly appropriate as it addresses relevant structural issues of the Montenegrin economy (upgrade of public infrastructures, reduction of the fiscal burden on labour, and ensuring an adequate functioning of the financial system). On the other hand, the intended size of the economic package seems too ambitious given the domestic and external constraints. Its implementation may be uncertain in case of severe underperformance of revenues in 2009 and the planned capital spending hike was already restrained during the adoption of the 2009 budget by the parliament. Also, for a small, non diversified and open economy like Montenegro's, a large increase in public spending and works is less likely to exert a substantial effect on economic activity in the short run, while the fiscal stimulus would add to the high level of external imbalances in the economy.

3.1. INTRODUCTION

In July 2006, the European Commission invited the potential candidate countries Albania, Bosnia and Herzegovina, Montenegro and Serbia for the first time to submit by 1 December 2006, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes (PEP) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

The 2009 EFP of Montenegro covers the period 2008-2011 and was submitted to the Commission within the deadline set for 31 January 2009. The programme was drafted primarily by the Ministry of Finance with input from other public institutions and is linked to the 2009 Budget and the 2009-2012 Medium-term macroeconomic and fiscal frameworks. The document is also guided by the main objectives deriving from the accession process summarised in the European Partnership priorities and the findings of the Commission's assessment of the economic Copenhagen criteria in its last Progress Report. The programme broadly complies in terms of content, form and data with the guidelines stated in the outline for the 2009 EFP. It takes into account many of the recommendations and suggestions provided by the Commission in the assessment of previous submissions. The main improvements relate to the presentation of alternative fiscal scenarios which are not only in line with the various macroeconomic scenarios developed, but also very beneficial due to the volatile economic conditions in a crisis environment. In addition, this year's programme focuses much more on the implementation and achieved results of structural reforms, including a quantification of their fiscal impact when possible. The 2009 EFP also provides a detailed description and quantification of the measures adopted in order to mitigate the effects of the economic and financial crisis as well as an estimation of the main transmission channels to the Montenegrin economy. Nonetheless, the quality and availability of statistical data remain weak, impacting on the comprehensiveness of the description of the 2008 developments. In a similar vein, the analysis of the recent and medium-term fiscal developments is based on the national accounting standards which differ from ESA 95.

The programme aims at maintaining fiscal discipline and the budget deficit below 2.4% of GDP in 2009, despite sizeable measures planned in response to the crisis. This would still imply a decline in the budget balance of around 4% of GDP as compared to 2008, but would maintain the deficit at a financeable level given the external financing constraints and the domestic risk of crowding-out private sector activities. Capital spending which was supposed to surge in order to stimulate economic activity would act as a buffer in case revenues fall more than expected on weak imports and indirect tax collection. Overall, the programme demonstrates sufficient commitment and flexibility to meeting the budget targets in 2009-2011, but the quality of the composition of budget spending may suffer, in particular after the large increases in current spending and commitments witnessed in the recent past.

Yet, the structural reforms will continue during the programme period in order to support the EU accession process.

3.2. ECONOMIC OUTLOOK

3.2.1. Recent macroeconomic developments

The economy has continued to grow strongly – close to 8% in real terms – in 2008, driven by strong demand and by services, of which mainly tourism and financial intermediation. In 2008, the industrial output contracted on the poor results of the manufacturing industry, and the metal sector in particular, which suffered from the international crisis and the accompanying decline of external demand and commodity prices. The current account deficit widened in absolute terms, at around 30% as a share of GDP. The stabilisation of the relative size of the deficit was mainly due to a strong cutback in merchandise imports during the last quarter (-45%). The services surplus remained positive, although deteriorating as imports of services rose considerably faster than corresponding exports (mainly tourism) in the three first quarters of the year. During 2008 the capital account still recorded robust net FDI of more than 17% of GDP, covering around 58% of the current account deficit. The strong growth benefitted labour market dynamics and the unemployment rate further decreased to 10.8% by years' end despite a significant level of temporary non-resident workers from neighbouring countries. Consumer prices kept accelerating during the first half of 2008, and moderated afterwards. The average annual inflation rate in 2008 remained high at 7.4%. An analysis of the labour cost versus labour productivity dynamics would have been beneficial given the large increase in wages (also driven by the public sector) whose implicit impact on external competitiveness is likely to be large.

The 2009 EFP provides a concise and accurate overview of recent macroeconomic developments at the time of submission. Data coverage has improved compared with previous submissions, however gross added value by economic sector and estimates of total external debt are still not provided. Given the high degree of uncertainty on the possible consequences of the global economic and financial crisis, the programme provides two alternative scenarios corresponding to different degrees of negative spill-overs from the crisis. The 2009 EFP investigates the main channels of transmission of the international crisis to the Montenegrin economy and provides a comprehensive list of the main risks surrounding the real, fiscal and financial sectors.

Table II.3.1:
Macroeconomic developments

	2007	2008	2009	2010	2011
Real GDP (% change)	10.7	8.1	2.5	3.5	4.5
<i>Contributions:</i>					
- Final domestic demand	19.6	14.2	4.2	5.5	6.7
- Change in inventories	1.1	0.7	0.2	0.2	0.1
- External balance of goods and services	-10.0	-6.8	-1.9	-2.1	-2.3
Employment (% change)	3.7	6.1	-3.0	1.9	3.1
Unemployment rate (%)	11.9	10.7	11.6	10.6	9.5
GDP deflator (% change)	18.1	10.0	6.0	5.0	4.0
CPI inflation (%)	7.7	8.0	5.0	3.5	3.0
Current account balance (% of GDP)	-29.8	-34.1	-20.9	-21.4	-24.7

Source: EFP 2009 submission, "crisis" scenario

Box II.3.1: The global financial crisis: First impact and policy response

Recent developments showed that the country will not be spared by the global economic crisis. The first effects are observed in the processing industry, and especially in the aluminium sub-sector. Output in the local aluminium smelter has declined almost by half as production costs remain very high while international prices of the metal declined sharply. Also the real estate sector has been adversely affected as some investments were postponed due to scarce capital and declining asset prices. During the last months of 2008 banks witnessed deposits withdrawals while the lending activity also decelerated. Yet, the widening gap was covered by foreign loans from parent banks abroad.

In response to the crisis, the government has planned a combination of measures to stimulate domestic demand and ensure a smooth functioning of the banking sector. On the fiscal side, the authorities had planned a significant increase in capital spending aimed at off-setting a potential serious decline in net FDI and domestic investment, but it was later downsized in the 2009 budget adopted by the parliament. This increase in spending is counterbalanced by a reduction of current budget spending. In addition, the rates of the personal income tax and social contributions were further reduced as well as other fees for businesses. The authorities adopted a law on the measures to protect the banking system, including a full guarantee of domestic deposits, provision of liquidity to banks through early debt repayment, recapitalisation by purchase of shares and provision of guarantees for the facilitation of an inter-bank market. The authorities also adopted a programme of reduction of electricity prices for the most vulnerable categories of the population, as well as for small and medium enterprises (SME). In addition, the government is ready to guarantee long-term credit lines to the banking sector in order to support SMEs. The programme provides a detailed estimation of the budgetary impact for each one of these measures. Overall, the stimulus package was initially evaluated at some 9.5% of the projected GDP for 2009. Should revenues fall short of their target, the authorities are committed to fiscal prudence, by capping the budget deficit to 2.4% of GDP and rolling back the planned increase in capital expenditures.

In February 2009, the authorities adopted additional measures to boost the liquidity of the banking system, in particular the provision of state guarantees for a EUR 150 million loan (some 5% of GDP) to provide credit support to local lenders. Also, the government will exceptionally permit commercial banks to use up to 20% of their mandatory reserves from the Central Bank to buy government bonds, while these funds (some 1.4% of GDP) are deposited back again in the same banks.

3.2.2. Medium-term macroeconomic scenario

At the on-set of the EFP drafting process in mid-summer 2008, the original baseline scenario was a close extrapolation of 2008 early trends and assumed a 7% growth rate for real GDP in 2009. As the unfolding of the global crisis accelerated, the authorities switched to two other, more pessimistic scenarios – a baseline "real" scenario assuming a growth rate of 5% in 2009 and a "crisis" scenario assuming a growth rate of 2.5% in 2009. The external outlook of the EFP is based on the IMF's autumn projections for the period 2008-2012, which are more optimistic than the Commission's autumn forecast. In comparison with the latest Commission forecast update in January 2009, the programme's external assumptions appear even less realistic due to the rapidly changing international economic environment. The programme could have also included different sets of assumptions according to each scenario.

The forecasting model used by the Ministry of Finance contains just some basic indicators, but the macroeconomic framework nevertheless seems consistent and sufficiently comprehensive. The scenario takes into account the impact of the reforms initiated in the previous period together with the expected fall-out of the global financial and economic crisis on Montenegro's real economy, financial

sector and fiscal stance. Although the "real" scenario projects declining growth in 2009 and 2010 from the record levels witnessed in 2007 and 2008 and a contraction of exports and FDI inflows, it appears to be optimistic given notably the very favourable external assumptions. The merit of the programme is that it provides an alternative "crisis" scenario integrating negative spill-overs from the crisis, thus being more realistic. The "crisis" scenario includes a much more pronounced reduction of growth and external deficits and for the first time, also a deterioration of conditions on the labour market. However the full magnitude of the adjustments to come may not yet have been contemplated in this "crisis" scenario. The policy-mix of the programme, which mainly relies on fiscal policy instruments given the use of the euro in Montenegro, was carefully calibrated so that it would comply with both alternative macroeconomic scenarios, but may also need to be revisited if the "crisis" scenario turns out to under-estimate the magnitude of necessary adjustments to come. The EFP includes a very detailed and thorough analysis of the main risks to the macroeconomic scenario while the impact of the global economic and financial crisis was also well captured.

Real sector

The baseline scenario foresees a limited impact of the global financial crisis on the local economy, revising annual real growth down to 5% in 2009 from 8% a year before, due to the contraction of credit activity and FDI inflows and their impact on aggregate demand. Yet, on a quarterly basis the deceleration path may be stronger by the end of 2009 and beginning of the next year, resulting in a similar growth rate of 5% also for 2010. However, it is less clear why growth would decelerate to around 4.5% in 2011 once the global crisis is expected to fade away and as credit activity and FDI inflows recover. In this scenario, employment will continue expanding by 3% every year, while unemployment still decreases although marginally. The real growth rates of gross fixed capital formation decline to single-digit figures in 2009 and 2010 and even turn negative in 2011, which appears to be conservative. However, the growth of net wages at double digit rates will still result in labour productivity losses.

The alternative or "crisis" scenario considers a more drastic deceleration of the economy to 2.5% in 2009, followed by a gradual recovery to 4.5% by 2011. All the negative impacts of the above mentioned baseline scenario have been toughened, resulting in a higher contraction of the aggregate demand, but also in the reduction of employment in 2009. Private consumption would increase by only 3.8% in real terms in 2009 over 2008 while investments are expected to decline in real terms by a double-digit rate. The severe contraction of FDI inflows will have a large impact on domestic demand as imports of goods and services are set to decline by around 20% in volume terms in 2009. Export growth is also likely to turn negative by around 7% due to the faltering external demand. The growth of wages is much more in line with labour productivity developments in this scenario. Given recent developments in Montenegro and a more pessimistic outlook of the global economy than envisaged in the programme, the "crisis" scenario appears to be the most plausible one.

Inflation

The use of the euro helped to provide Montenegro with a high degree of price stability during the past. Yet, the sharp increase of world commodity prices during the second half of 2007 and early 2008 did not spare the country, and resulted in an upsurge in headline inflation. External factors have a stronger effect on domestic prices than local ones, including wages, as most of domestic demand drives imports flows rather than pressing on the narrow domestic production. The same disinflation path is presented in both scenarios and assumes a gradual deceleration of the average price increase from 5% in 2009 to 3.5% in 2010 and 3% in 2011. The EFP explains the improved stability of prices through the moderate increase in domestic demand which makes the chosen disinflation path more compatible with the more conservative "crisis" scenario.

Monetary and exchange rate policy

The country's unilateral euroisation implies that there is only limited scope for the use of domestic monetary instruments. As interest rates follow the euro area money markets, domestic activities should benefit from the recent cuts in policy rates by the European Central Bank, although the increase in risk premia for emerging markets since the on-set of the crisis mitigates this effect. The rapid pace of credit growth has declined from around 165% year-on-year in 2007 down to 23% annual expansion by end of the year, well below the Central Bank's target of 40%. Significant deposit withdrawals took place since late 2008 and the rate of non-performing loans increased. Yet, the largely foreign-owned banking sector (9 out of 11 banks are foreign owned) appears as relatively sound, except for the domestically-owned Prva Banka which needed a government recapitalisation of around 1.3% of GDP in late-2008. The EFP presents the package of measures adopted to support the banking system and the main risks surrounding the financial system in the crisis. Overall, continued parent bank support is necessary to preserve the stability of the financial system and support economic activity.

External sector

Most of the economic and fiscal developments are tightly linked to the evolution of the external sector. Montenegro is a small and very open economy which in the last years has benefited from high levels of FDI inflows, tourism revenues, and foreign loans to domestic banks. All these resulted in soaring levels of imports, pushing the current account deficit to record-high levels (around 30% of GDP in 2008). The trade balance is also suffering from the deteriorating terms of trade faced by the main export activity, the aluminium industry, which represents roughly half of the visible trade outflows. The impact of the economic crisis on the international capital inflows and domestic demand will reduce imports as well as the financing needs, and henceforth improve the trade balance, bringing the current account deficit down.

In the alternative "crisis" scenario, the contraction of the current account deficit will be much stronger as the gap is projected to contract to some 21% of GDP in both 2009 and 2010. This assumption appears to be more realistic due to the present turmoil on international capital markets which reduces FDI prospects and access to external financing. The expected contraction of net FDI from past record levels (close to 20% of GDP per year) to below 10% of GDP during the period 2009-2010, will still provide a 40-45% coverage of the projected current account deficits. In addition the programme appears rather conservative on its estimate of FDI inflows, as only the investment projects which are already underway represent around 10% of GDP in 2009. Yet, given the large list of projects announced, the upside risks to the programme's projections remain large resulting in a possible improvement of the FDI coverage of external deficits in 2009-2010. Based on these conservative assumptions, the "crisis" scenario assumes a depletion of central bank's foreign reserves of around EUR 100 million in order to close the external financing gap in 2009, followed by a replenishment of reserves starting from 2011. At the end of 2008, the central bank's net foreign reserves stood at around EUR 200 million.

Main risks to the macro-economic scenario

The programme provides a detailed list of risks classified in three groups pertaining to the real, fiscal, and financial sectors. These are summarised in one common chart, giving a fairly broad overview of the transmission channels of such risks to the Montenegrin economy. As mentioned before, FDI developments remain a major uncertainty with a large disruptive potential in case of a sharp contraction. The impact would relate to several economic processes: lower asset prices (real estate and stock market in particular), contraction of imports, constructions, and bank deposits. Tourism represents another external risk for the real economy, and notably on employment. All these negative effects combined may jeopardise the achievement of the fiscal revenues target. The situation could be further worsened if some of the privatisation projects do not take place because of lack of investors' interest or just because bidding prices are too low. Overall, the programme appears to take into

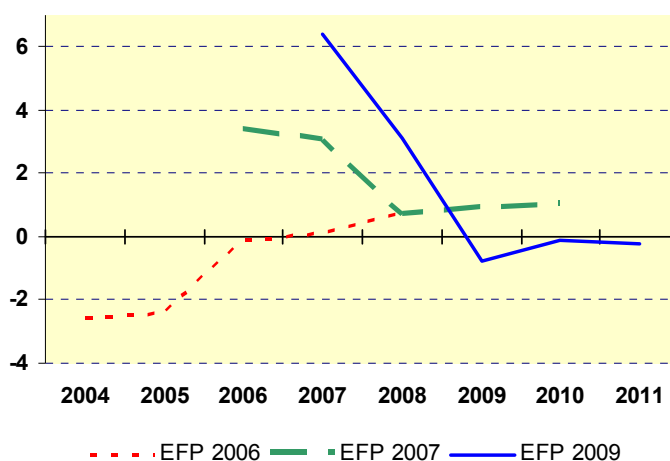
account the most relevant risks surrounding the economic activity in 2009 and 2010, but may have underestimated their magnitude. The review of the uncertainties surrounding the financial sector, in terms of decreasing lending, withdrawal of deposits and problems encountered by an important domestic bank would have warranted a more detailed analysis.

3.3. PUBLIC FINANCE

The fiscal framework is well-integrated in the overall policy objectives of the programme and is largely consistent with the main macroeconomic assumptions. As the macroeconomic framework provides alternative scenarios, also the public finance framework was built on three different scenarios. The programme explains well the main objectives of fiscal policy in the medium-term and the planned measures on the revenue and expenditure side are adequately described. To the extent that the measures are part of the economic stimulus package they are also quantified. On the other hand, a more comprehensive description of the budgetary execution in 2008, including the factors that led to the increase in public spending would have been welcome. The tables provided in the text could have been more detailed as regards the main revenue and expenditure items. A few inconsistencies between the text and the tables could be noted. Fiscal risks are well described and cover the impact of the on-going economic and financial crisis. The accounting rules are based on the IMF Statistics Department's Government Finance Statistics Manual 2001 (GFSM 2001), while the debt accounting also relies on the European System of Accounts standard (ESA95). Data provided in Table 2 of the Annex "General government budgetary prospects" are supposed to be compliant with the ESA 95 standards, but the analysis and tables provided in the text are based on the usual accounting rules. Therefore the present assessment refers to the figures and fiscal developments included in the text and not in the Annex.

Under the three scenarios included in the fiscal framework, one corresponds to the optimistic macroeconomic assumptions included in the draft budget for 2009, assumptions which were later considered as too outdated to be presented in detail in the EFP. The programme acknowledges the fact that the 2009 draft budget is rather optimistic and therefore presents two alternative fiscal scenarios which in turn correspond to the "real" and "crisis" macroeconomic scenarios. The main objective of the fiscal strategy is to keep the budget deficit below 2.4% of GDP in 2009 under the more pessimistic scenarios, amount which is considered financeable and compatible with a sustainable path of public finances in the mid-term. As the level of projected revenues declines more under the "crisis" scenario, a decrease of capital spending would be necessary to meet the deficit target. Given however that fiscal policies were pro-cyclical in recent high growth years, the margins of manoeuvre of fiscal policy in the on-going crisis have been somewhat reduced. In case actual fiscal revenue falls short of planned amounts in the course of 2009 – which seems increasingly likely – more ambitious budget rebalancing measures than the ones so far contemplated in the 2009 EFP programme will rapidly appear unavoidable.

Graph II.3.1: Budgetary developments (general government balance, % of GDP)



3.3.1. General government balances and debt

Actual balances and medium-term perspectives

The programme expects the 2008 budget execution to end with a surplus of 1.4% of GDP, which is more favourable than the close to balance target of the 2008 budget. The achievement also exceeds last year's programme target which stood at 0.7% of GDP. The improvement was primarily due to over-performing revenues while spending also increased but to a lesser extent. On the revenue side, the better than expected tax collection providing excess revenues of about 4.7% of GDP was driven by surging indirect and corporate income taxes. The increase in public spending was caused by a significant boost of public sector wages in excess of 30% y-o-y and the harmonisation of pensions which implied the payment of long due obligations to pensioners. As a result, the programme expects public spending to have increased by 3.1% of GDP in 2008 over the year, including current transfers topped by some 3.5% of GDP. Some of the factors leading to the higher than planned budgetary outlays in 2008 only had a one-off fiscal impact. On the other hand, the higher public sector wages and pensions are permanent commitments, which are likely to exert fiscal pressures also in the coming years when budget revenues are expected to deteriorate. This pro-cyclical stance in 2008 may hence have contributed to exacerbate external imbalances and increased Montenegro's exposure to the unfolding of the crisis.

The fiscal framework includes three fiscal scenarios. The most optimistic one roughly corresponds to the preliminary 2009 draft budget adopted by the Montenegrin cabinet. As the effects of the crisis became more apparent, the draft budget was revised and the 2009 budget adopted by the Parliament corresponds closely to the second "real" scenario presented in the EFP in terms of revenues projected at around 1.6 billion euro. On the other hand, the budgeted expenditures are lower than in the EFP "real" scenario and the adopted budget actually targets a deficit of around 1.5% of GDP, smaller than the deficit of 2.4% of GDP provided in the EFP "real" scenario. As a consequence, the EFP fiscal framework deviates from the 2009 budget adopted by the Parliament, but the conservative revision of the draft budget and the inclusion of more pessimistic scenarios in the programme show the authorities' willingness to take corrective action promptly in order to meet the deficit target in 2009. Faced with lower-than-expected collection of revenues since the beginning of the year, the

government recently decided to tighten the fiscal policy and further curtail expenditures. This also indicates that the budget may need to be revised rather soon – notably in view of apparently weak revenue performance over the first two months of the year- by bringing it closer to the parameters of the "crisis" fiscal scenario. This scenario is also more in line with the "crisis" macroeconomic scenario which we consider to be the most plausible outcome for 2009/2010. Accordingly, revenues are likely to decline marginally in nominal terms and fall below 40% of GDP in 2009 from around 45% of GDP in 2008. The government will probably have to resort to the contemplated option of cutting capital expenditures by around 4-5% of GDP from the planned level in order to maintain the budget deficit below 2.4% of GDP. The 2009 budget adopted by the Parliament already provides a reduction in the capital budget by more than 3% of GDP compared to initial plans, thus supporting our assumptions. In February, the government decided to further curtail expenditures in view of the lower than expected revenue collection since the start of the year and to freeze the expansion of the public administration, the appointment of consultants as well as expenditures in maintenance and purchases of goods and services, while other current expenditures are being reduced to the minimum.

For the years 2010 and 2011, the "crisis" fiscal scenario estimates a recovery of the growth of nominal revenues by around 8% annually which would increase the revenue levels to some 43% of GDP. Public spending is projected to increase at a slower pace, so that the budget deficit would gradually shrink from 2.4% of GDP in 2009 to 1.6% of GDP in 2010 and 0.7% of GDP in 2011. Capital spending would only recover slowly from 5.9% of GDP in 2009 to 7.1% of GDP in 2011, below the level of around 10% of GDP originally expected for 2009 under the more optimistic scenarios. Current public consumption is likely to peak to almost 39% of GDP in 2010 to decline later to some 37% of GDP in 2011.

The main fiscal risks identified by the programme appear quite relevant. The most important one relates to the strong dependence of budget revenues on indirect taxes and in particular on the ones levied on imports (custom duties, VAT revenues and receipts from excises). This is a direct result of the tax-rich pattern of growth witnessed in recent years which led to an exponential growth of revenues in parallel with the staggering growth of imports. To the extent that foreign capital inflows and imports will slump in 2009 and 2010 the risk of falling revenues becomes tangible. As a result, permanent increases in real spending committed in previous years will impact on fiscal sustainability. Other potential risks stem from the quasi-fiscal liabilities assumed by the government either in the process of returning seized property to citizens or in the set of measures aimed at supporting economic activity and in particular the banking sector. Amendments to the Law on restitution have significantly reduced the first category of risks by limiting annual payments to a level of 0.5% of the estimated GDP. The second category of risks remains an open issue as the government guaranteed all deposits in the banking system and inter-banking loans. The recapitalisation of Prva Banka in the fall of 2008 necessitated a public loan of around 1.3% of GDP (guaranteed with 93% of the bank's shares). Nonetheless, the authorities are also aware of the restrained access to broader external financing during the crisis which is significantly reducing their manoeuvring space in the fiscal area. The additional funding of infrastructure projects and in particular of the highway Bar-Boljare may lead to a significant increase of the budget deficit unless a proper arrangement in terms of the public-private sharing of risks and costs will be used .

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

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	47.7	45.9	39.6	43.1	42.8	-3.1
<i>of which:</i>						
- Taxes and social security contributions	38.8	37.2	33.8	37.7	37.5	0.3
- Other (residual)	8.9	8.7	5.8	5.4	5.3	-3.4
Expenditure	41.4	44.5	42.0	44.8	43.5	-1.0
<i>of which:</i>						
- Primary expenditure	40.4	43.9	41.1	44.0	42.7	-1.2
<i>of which:</i>						
Gross fixed capital formation	7.4	6.0	5.9	6.8	7.1	1.1
Consumption	19.1	17.5	16.4	17.1	16.4	-1.1
Transfers & subsidies	13.2	19.8	18.0	19.5	18.6	-1.2
Other (residual)	0.7	0.6	0.8	0.6	0.6	0.0
- Interest payments	1.0	0.6	0.9	0.8	0.8	0.2
Budget balance	6.3	1.4	-2.4	-1.7	-0.7	-2.1
Primary balance	7.3	2.0	-1.5	-0.9	0.1	-1.9
Gross debt level	27.5	27.8	41.2	40.7	39.7	11.9

Sources: EFP 2009 submission, "crisis" scenario, ECFIN calculations

Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

Public debt as a share of GDP remained broadly unchanged in 2008 at around 28% of GDP. Yet, the domestic public debt increased in nominal terms by more than 50% in 2008 from 2007 primarily due to the compensation of due pension rights, the recognition of the state's liability on frozen foreign exchange deposits and the assumption of public enterprise debts and in particular the obligations of the Montenegrin Railways. This was partly compensated by a decline of external obligations. Net public debt is likely to be lower as the Ministry of Finance and the municipalities held deposits of around 4.5% of GDP at the end of 2008. The "crisis" scenario, which is the most plausible fiscal outcome, projects an increase in public debt to 41.2% of GDP in 2009 and a subsequent stabilisation at around 40% of GDP in 2010 and 2011. The significant increase of public debt reflects the deterioration of the budget balance, and further repayments of pension arrears. Yet, pending legal proceedings' outcomes the full amount of public debt remains uncertain. These projections however do not take into account other potential obligations arising from the financing of the Bar-Boljare highway, or the blanket guarantee given to the banking sector.

The currency structure of the debt is rather favourable as domestic debt and about 70% of the external debt obligations are denominated in euro. Also the interest structure is beneficial as most of the external debt is on concessional terms with interest rates between 2 and 5.5%. In addition, the domestic debt from liabilities on the basis of restitution and foreign currency deposits bears an interest rate of 2%. Budget interest payments are correspondingly low at below 1% of GDP. While total restitution claims are limited by the Parliament to 10% of GDP, of which only a portion will be included in the 2009 debt figures once the claims are accepted. However, the rapidly rising contingent liabilities of the banking sector may disrupt the projected public debt path.

Budgetary implications of "major structural reforms"

The programme provides a good overview of the budgetary impact in 2009 of structural reforms in several areas, such as privatisation, elimination of business barriers, improvement of the road infrastructure, labour market reforms and the use of EU pre-accession funds. The programme foresees revenues from privatisations of around 1% of GDP, whereas the other reforms described will necessitate budgetary outlays of around 5% of GDP. All the mentioned reforms are likely to contribute to the improvement of the country's growth potential. The package of measures adopted in order to alleviate the impact of the global crisis is also well described and quantified. The estimated size of the package of around 9.5% of GDP is fairly large, but its budgetary impact is likely to be much lower. A major part of the measures refer either to the reduction of unproductive government consumption spending and the issuance of loan guarantees or are unlikely to materialise, as in the case of the large budgeted public spending which would be cut significantly if revenues underperform.

3.3.2. Quality of public finances

The programme addresses the issue of improving the quality of public finances, as in previous years, through reducing the fiscal burden for the economy and citizens, and reducing the share of public expenditures in GDP. The first policy objective was attained by lowering the corporate profit tax rate to 9%, one of the lowest rates in the region and the gradual reduction of the rates for corporate income tax and mandatory social contributions. As of 2009, the personal income tax rate further declined to 12% from 15% in 2008 while the total rate for mandatory social insurance was reduced to 32% from 34% in the previous year. The second policy objective has not been consistently pursued. On the contrary, public spending has increased by some 3% of GDP in 2008 against the backdrop of a surge in budget revenues. The programme expects a reduction of the share of public expenditures in GDP in 2009, followed by a rebound above the 2008 level in 2010 and remaining close to the level of 44% of GDP in 2011.

In 2008, current spending and in particular the public sector wage bill and transfers were the main contributors to the increase in budget expenditures. In 2009 and 2010 the quality of the composition of public spending may further deteriorate, should capital spending be primarily used as a buffer to offset lower-than-expected revenues to preserve the deficit target.

3.3.3. Institutional features of public finances

The programme provides a good overview of the actions taken to improve the budgetary process. The authorities further improved the efficiency and transparency of the budget process by amending the "organic" Law on the budget and the Law on the financing of local government. The new legislation consolidates debt and cash management thus linking it with the laws on the annual budgets. At the same time, the merger of non-budgetary funds into the treasury system was an important measure in the process of budget consolidation. The programme could have also covered latest developments on the Law on internal audit in public sector, the Law on accounting and auditing and the reform of financial reporting of companies. The implementation of the medium-term budget framework with spending limits for all budget units and the full introduction of programme budgeting, remain key challenges for a more efficient utilisation of financial resources.

3.4. STRUCTURAL REFORMS

The 2009 EFP includes a very comprehensive and exhaustive section of structural reforms which comprises the enterprise sector, the financial sector, the labour market, and administrative reforms. There is a clear commitment of the authorities to growth-enhancing reforms that are linked to the accession process. The presentation is coherently structured and includes quantitative estimates of the impact of reforms and in most instances a consistent timetable for their implementation. However, the

focus could have been more balanced between the backward-looking description of past reforms and a more forward-looking presentation of planned activities.

The reform strategy is widely supportive to the fulfilment of the Copenhagen economic criteria and generally follows the findings of the Commission's Progress Report. The main objective of the reform agenda is the creation of a more flexible and competitive business environment, thereby increasing productivity and making the country more attractive for investors. Reforms in the labour market and the energy sector deserve special attention in that regard. The privatisation process of the electric company is well advanced.

3.4.1. Structural reforms and European Partnership

The programme reveals a rising awareness of policy makers in the country about some of the reform areas that are highlighted in the European Partnership. It addresses economic priorities such as the establishment of more flexible labour markets, the improvement of the business environment, the adjustment of fiscal policies, the approximation of relevant trade laws in the context of the implementation of the Stabilisation and Association Agreement or the continuation of the privatisation process.

3.4.2. Product and capital markets

The privatisation process is at an advanced stage. While the EFP displays a clear picture of the main companies listed for privatisation, an indicative timetable for its finalisation would have been welcome. Expected revenues from privatisation in 2009 amount to 1.3% of GDP which is significantly below the figure outlined in the previous EFP (2.4%). It is not discussed to what extent the decreased propensity of investors to invest in the context of the current economic crisis may have an impact on the speed of the privatisation process in Montenegro.

In the area of competition, state aid and public procurement, Montenegro is making continuous progress. The Administration for Competition Protection was founded and a strategy of competition policy was adopted, aiming at the compliance of competition policies with the *acquis*. Similarly, a Commission for Control of State Support and Aid was established in March 2008. An analysis in the EFP of how these institutional changes have an impact on the business environment would have been helpful. The decreasing trend of the share of state aid to GDP from 3.4% in 2005 and 2006 to 1% in 2007 reveals the commitment of authorities to reduce this type of market intervention but may not hold in the context of the crisis as measures such as the rescue of Prva Banka may considerably inflate aid levels. Measures that directly address the business environment include the promotion of SME activities, the removal of business barriers and tax policy. The reduction of personal income tax rates and social contribution rates as of 2009 will have a positive effect on the labour supply and demand.

As identified already in the assessment of the previous EFP, the reform of the energy sector remains crucial given its broad impact on the economy. A number of measures have been introduced by the government to reduce the electric power deficit hindering economic development. The 2009 EFP describes the main activities foreseen in the Action Plan 2008-2012 for the implementation of the Energy Development Strategy which focuses on increasing energy efficiency, however, without revealing concrete measures. Additionally, the exploration of renewable energy sources will be promoted. The budgetary costs of the implementation of the Action Plan in 2009 amount to 0.8% of GDP. The electricity consumption of poor households will be subsidised under a programme established for the period November 2008 until October 2009, while the overall cross-subsidisation between household and enterprise sector was further reduced, but not yet fully abolished. Prices of oil derivatives are controlled. The programme would have benefitted from a more in-depth analysis of the restructuring and privatisation process at Elektroprivreda Crne Gore (EPCG), the incumbent electricity operator.

The banking sector appears broadly sound under foreign ownership. The programme describes the measures taken by the Central Bank before the outbreak of the financial crisis in order to cool down the highly expansive credit growth experienced in 2006 and 2007. These measures were partly successful, as they brought down annual credit growth from 165% in 2007 to 23% in 2008. The EFP claims that the financial crisis has not had any direct effects on the Montenegrin banking sector, as it is not directly exposed to the US subprime market. It nevertheless acknowledges the possible indirect impacts of the global slowdown of growth on the stability of the Montenegrin financial sector and its refinancing possibilities. In the last months of 2008, some deposit withdrawals were observed and the government adopted an urgent law to protect the banking system, including a generous guarantee scheme up to the full amount of deposits and guarantees for interbank loans. Additionally, the Central Bank changed reserve requirements in order to safeguard the liquidity of the banking system. An assessment of how risks have been managed during the ongoing financial crisis would have been useful. Furthermore, the stability situation of the financial sector could have been more extensively explored. Concerning capital markets, the programme emphasizes the need to further strengthen the regulatory framework.

3.4.3. Labour market

The programme elaborates on several key aspects of the labour market. The rate of registered unemployment was reduced from 11.7% in 2007 to 10.8% at the end of 2008 and it is expected to fall below 10% by 2010. In the light of the global economic crisis this may be an optimistic assumption. Under the "crisis" scenario, unemployment is projected to rise above 10% by 2010. Active labour market policies are supplemented by structural reforms. In this respect, a new labour law was adopted in July 2008 which is based on the "flexicurity" concept, enabling more flexibility to employers to negotiate working conditions while providing employees with improved social security. A Social Council was created whose mandate is to resolve disputes between trade union and employers, with the participation of the government, in a concerted way. Furthermore, the pension system reform is continued with the ultimate goal to replace the current pay-as-you-go system by a capitalised system. A third pillar has already been introduced, based on voluntary pension funds. These measures are overall conducive to a higher employment rate by reducing structural rigidities, while contributing to reduce budgetary strains.

3.4.4. Other reform areas

The 2009 EFP highlights several administrative reforms. The restructuring of public administration is continued with a focus on strengthening administrative capacity for the process of European integration. The free movement of labour and capital is further enhanced and reforms are planned or on-going in a number of other areas, such as information society, rural development, statistics, regional policy, judiciary, education, environment, and consumer protection. The programme is very detailed in the description of these reforms. However, the link to the overall objectives of the programme is not always clear. Nevertheless, the reform agenda can be broadly endorsed. Finally, it describes the establishment of a de-centralised implementation system for EC's Instrument for Pre-accession Assistance (IPA) to help improve the efficient use of these funds.

* * *

4. SERBIA

SUMMARY AND CONCLUSIONS

- In January 2009, Serbia submitted to the European Commission a Memorandum on the Budget and Economic and Fiscal Policy for the year 2009 with projections for 2010 and 2011. The document is broadly in line with the content, form and data suggested for the 2009 Economic and Fiscal Programme (the 2009 EFP). It presents a generally coherent macroeconomic framework, including projections for key macroeconomic variables and medium-term fiscal targets. The document could help to align the country's policy mix with the economic conditions and the country's orientation towards meeting the economic Copenhagen criteria for EU membership.

- The macroeconomic framework presented in the 2009 EFP is coherent, consistent and sufficiently comprehensive. It does not provide alternative scenarios. However, the direction of the programme's main objectives and intermediate goals appear too optimistic given the rapid deterioration of the global economic environment and its impact on Serbia. The proposed moderate fiscal adjustment may not be sufficient to compensate for the likely deterioration in public finances, in particular a decline in public revenues, but also an increase in public expenditures. The analysis of the main risks to the macroeconomic scenario is credible but the impact of the global economic and financial crisis is not fully reflected in the programme projections.

- The fiscal framework is well integrated into the overall policy objectives, and based on the presented medium-term economic framework. It is overall coherent and consistent, however not very realistic against the backdrop of the current global economic and financial crisis and its impact on Serbia. The fiscal strategy of the presented programme is to reduce public expenditures as a share of GDP by 0.8 percentage points and to reduce the fiscal deficit from 2.2% to 0.7% of GDP over the programme horizon. The key measures on the revenue and expenditure side are explained to some extent, but the programme would have benefited from a quantitative impact assessment of the most important fiscal measures. Even though fiscal risks are comprehensively identified, their presentation could have benefited from additional information and quantification.

- Overall fiscal policy options are very limited also in view of the pro-cyclical policies of recent years. While external imbalances remain high, although adjusting rapidly in the course of the current crisis, restrictive fiscal policies will need to help further support the much needed adjustment process. In addition, the crisis related decline in public revenues and limited prospects for realising privatisation proceeds limit the scope for financing fiscal expenditures and deficits. While access to financing, either international or domestic, has become more expensive, room for increasing taxes is limited due to the already high level of taxation. At the same time, expenditures are set to continue rising in 2009, due to permanent expenditure increases during 2008, primarily for public sector salaries and pensions. These antagonistic developments will exert substantial pressures on public finances in the coming year. Therefore, it is recommended that the Serbian authorities change course and take measures to reverse the substantial increases in current expenditures of past years.

- The 2009 EFP presents a comprehensive structural reform framework, covering a wide range of structural reforms related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. The programme gives sufficient space to measures to improve the overall business and entrepreneurial environment and to attract foreign investors. However, the 2009 EFP does not sufficiently address the much needed reform of the pension and health systems. The relation between the structural reform agenda and the fiscal strategy could have been stronger. In particular, structural

reforms that may have sizeable budget effects, in particular enterprise restructuring and privatisation, need to be put on top of the policy agenda, with a view to cut wasteful subsidies to unviable enterprise and increase privatisation revenues. The programme would have benefited from the presentation of clear timetables for the implementation of the most important structural reform measures.

- Main risks related to the 2009 EFP stem from the uncertainty about the possible effects of the unwinding of the global economic crisis on Serbia which may severely affect the macroeconomic and fiscal scenarios and especially budget revenue assumptions.
- The programme's reform agenda is broadly consistent with the fiscal scenario and generally aligned with the reform requirements in view of the country's EU accession perspective, as spelled out in the latest Progress Report and the European Partnership.

4.1. INTRODUCTION

In July 2006, the European Commission invited the potential candidate countries – i.e. Albania, Bosnia and Herzegovina, Montenegro and Serbia – for the first time to submit, an Economic and Fiscal Programme (EFP) to the European Commission. The EFPs are a further step towards an increased policy dialogue on economic and fiscal issues between the authorities of the potential candidate countries and the European Commission. The scope and content of the EFP is similar to the Pre-accession Economic Programmes (PEP) which are submitted each year by candidate countries, although the EFPs are somewhat more limited in scope.

By 31 January 2009, Serbia submitted to the European Commission a Memorandum on the Budget and Economic and Fiscal Policy for the year 2009 with projections for 2010 and 2011. The submitted Programme was not a stand-alone document but was prepared by the Ministry of Finance to lay the foundation of the republican draft budget for 2009 and was adopted by the government of Serbia in October 2008, in line with the requirements of the Serbian budget system law. The adoption of the 2009 budget was delayed until end December due to discussions with the IMF on a precautionary Stand-by Agreement. The submitted document is sufficiently linked to the objectives derived from the 2008 Progress Report and the European Partnership Priorities.

The submitted programme complies broadly with the guidelines stated in the outline for the 2009 EFP in terms of content, form and data. However, the required tables were not completed. While the programme provides a complete summary of recent macroeconomic performance, the macroeconomic and fiscal frameworks are based on too optimistic assumptions and are therefore not realistic. The assessment of structural reforms is broadly comprehensive, but would have benefited from an inclusion of the much needed pension and health sector reform. Fiscal data of the Republic of Serbia are presented in line with the Government Financial Statistics (GFS) methodology.

4.2. ECONOMIC OUTLOOK

4.2.1. Recent macroeconomic developments

In 2008, the Serbian economy was increasingly affected by the global economic and financial crisis, mainly through the slowing of its main export markets and a decline in capital inflows. While Serbian banks were not directly affected by the decline in asset values of mortgages related structural products, the adverse effects of the financial crisis on global asset and credit markets were increasingly felt domestically. In addition, slowing economic activity of Serbia's main export markets resulted in export growth to slow to 18.6% year-on-year from 25% a year earlier. As a result, Serbia's

GDP growth is estimated to have slowed to 6.0% in 2008 from 7.1% a year earlier. Inflation accelerated to an annual average of 11.0% year-on-year from 6.8% in 2007, primarily driven by the evolution of the oil price on global markets, but also due to higher electricity and telecommunication costs. The current account deficit widened to 18.3% of GDP from 14.7% a year earlier. While capital inflows remained substantial at 16% of GDP, they fell short of the high financing needs and, as a consequence, foreign exchange reserves declined. The still substantial economic growth was not sufficient to generate net meaningful additional employment, and unemployment remained at 18.8%. Average net wages slowed to 5.0% year-on-year in real terms.

Overall, the programme covers broadly all available data at the time of submission. However, the external assumptions are outdated. In addition, the presentation of the past economic developments is to a large extent descriptive without providing much analysis or explanation. The impact of the global economic and financial crisis is taken into account.

Table II.4.1:
Macroeconomic developments

	2007	2008	2009	2010	2011
Real GDP (% change)	7.1	6.0	3.5	4.5	6.0
<i>Contributions:</i>					
- Final domestic demand	14.4	10.3	1.7	5.3	6.5
- Change in inventories	0.0	0.0	0.0	0.0	0.0
- External balance of goods and services	-7.3	-4.3	1.8	-0.9	-0.5
Employment (% change)	-1.2	0.0	-0.5	0.5	0.5
Unemployment rate (%)	18.8	18.8	19.0	18.7	18.2
GDP deflator (% change)	9.4	11.0	7.9	7.2	6.3
CPI inflation (%)	6.8	11.1	8.2	7.2	6.2
Current account balance (% of GDP)	-14.7	-18.3	-16.3	-15.7	-14.4

Source: EFP 2009 submission

Box II.4.1: The global financial crisis: First impact and policy response

The global economic and financial crisis is affecting Serbia mainly through a slowdown or recession of its main export markets and a decline in capital inflows. The Serbian dinar depreciated in the second half of 2008 and has further lost 6.7% vis-à-vis the euro since the beginning of 2009. The National Bank of Serbia has repeatedly sold foreign exchange to boost liquidity of the interbank foreign exchange market. However, reserves remain at a comfortable 28% of GDP. Credit to households and enterprises continued to grow in January, but growth has been slowing from high levels in recent years. The average degree of indebtedness of Serbian households, although often linked to foreign currency, is relatively low, as a result of restrictive prudential requirements of the National Bank of Serbia in the past. The Serbian banking system, which is to a large extent in foreign hands, remains according to latest available data, liquid, well capitalised and profitable. There is however growing evidence that the ratio of non-performing loans, in particular to the corporate sector, has recently increased. Fiscal developments were unfavourable in January, as revenues declined by 14% year-on-year while expenditures grew by 13%, the latter due to significant increases in salaries and pensions.

The Serbian authorities adopted a number of measures to mitigate potential shocks that may arise from the financial crisis.

Monetary Policy – administrative and regulatory measures

The majority of measures were aimed at improving domestic and foreign exchange liquidity of the banking system under circumstances of tighter external financing conditions.

- Measures to promote domestic savings and stock exchange trading, including an increase of the guaranteed deposit amount to EUR 50,000, repeal of tax on interest accruing on FX savings, repeal of capital gains tax and repeal of tax on transfer of absolute rights;
- Cancelling of the mandatory bank reserve for new foreign loans, with a view to boosting liquidity;
- Suppressing early repayment charges, in cooperation with banks, except for the refinancing of loans with another bank, with an option to extend loan repayment periods up to one year, as well as an option to convert debt to other currencies;

Fiscal policy measures

- Within the framework of fiscal policy, the plan is to curb budget deficit at 1.5% of GDP through lower current public spending, while at the same time maintaining the current level of capital spending;
- The authorities agreed in November 2006 a 15-months precautionary stand-by agreement with the IMF, which allows Serbia to draw up to EUR 400 million if needed. The programme was approved by the IMF board on 16 January 2009. However, against the backdrop of a deterioration of public finances, the IMF programme was revised in March, substantially increasing the amount of funds available to Serbia to EUR 3 billion over 2009-2010.
- The government adopted a set of measures that aim at offsetting the effects of the global economic crisis on the country, including soft loans and guarantees. This aims at injecting liquidity in the economy, financing investment and stimulating consumption of domestically produced goods. In addition drawings from international development banks will help financing SMEs.

4.2.2. Medium-term macroeconomic scenario

The external outlook described in the 2009 EFP is based on IMF estimates of October 2008. As a consequence, it appears that the 2009 EFP assumes a too favourable international economic environment, which may render the assumptions for Serbia's economy too optimistic as well.

The framework presented is coherent, consistent and sufficiently comprehensive. It does not provide alternative scenarios. However, the direction of the programme's main objectives and intermediate goals appear too optimistic given the rapid deterioration of the global economic environment and its impact on Serbia. The proposed moderate fiscal adjustment may not be sufficient to compensate for the likely deterioration in public finances, in particular a decline in public revenues, but also an increase in public expenditures. The analysis of the main risks to the macroeconomic scenario is credible but the impact of the global economic and financial crisis is not fully reflected in the programme projections.

Real sector

Real GDP growth is projected to slow to 3.5% in 2009, accelerate again to 4.5% in 2010 and to 6.0% in 2011. The substantial downward revision of the growth profile from the previous EFP is attributed to the significant impact of the global economic and financial crisis on Serbia. On the demand side, the contribution of final domestic demand is projected to decline substantially but to remain positive at 1.7 percentage points in 2009 and to recover to 5.3 and 6.5 percentage points in 2010 and 2011, respectively. The contribution of private consumption is projected to drop to 2.4 percentage points in 2009 and recover modestly thereafter. Investment is foreseen to contribute negatively - by -0.9 percentage points - to 2009 GDP, but to recover substantially in 2010 and 2011. The contribution of net exports is assumed to be a positive 1.8 percentage points in 2009 but to turn negative again thereafter.

On the supply side of GDP, the contribution of the agricultural sector to GDP is projected to decline moderately to 0.4 percentage points in 2009 and to 0.3 percentage points thereafter. Industry and construction are assumed to contribute 0.6 and 0.1 percentage points, respectively in 2009, only slightly below the 2008 level, and to recover strongly to 1.0 and 0.3 percentage points by 2011. The contribution of the service sector, which has been a major driver for growth in recent years, is projected to decline to 2.1 percentage points in 2009 and to recover to 4.5 percentage points in 2011.

Employment is projected to decline by 0.5% in 2009 and but to recover thereafter and to grow by 0.5% per year 2010. Growth of labour productivity is expected to slow to 4.0% in 2009 and to accelerate again to 5.5% by 2010.

The 2009 EFP projects average annual growth at 4.7%, below the estimate for potential output of 6.0%.

Inflation

Inflation is projected to decline to 8.2% in 2009 and gradually continue declining by 1 percentage point per year until 2011. The recent high volatility of oil prices and the dinar exchange have contributed to persistently high inflation expectations in Serbia, which remains one of the main drivers of inflation.

Monetary and exchange rate policy

The National Bank of Serbia's announced primary policy objective is to achieve stable inflation, while supporting the government's economic policy to reduce the external imbalance and to boost economic

growth, without compromising its primary objective. At the beginning of 2009, the National Bank of Serbia changed its policy objective from targeting core inflation to headline consumer price inflation and has set the inflation objective for 2009 at 6-10%. While the National Bank of Serbia has announced to limit foreign exchange market interventions to limit extreme fluctuations of the exchange rate from occurring, it has repeatedly intervened in the interbank foreign exchange market, in particular following the escalation of the global economic and financial crisis in the fall of 2008, to boost foreign exchange liquidity, which at times had completely dried up.

External sector

The current account deficit is projected to decline by 2 percentage points to 16.3% in 2009 and thereafter gradually to 14.4% by 2011. Against the backdrop of the current economic and financial crisis and the related strong decline in domestic demand, the projected limited improvement of the current account deficit in 2009 seems unrealistic. In addition, the decline of commodity prices, in particular for oil, during the second half of 2008 and its likely continuation during 2009, will continue to exert downward pressures on the current account deficit. Already during the fourth quarter of 2008, the current account deficit fell to 15% of GDP, a trend which is likely to continue in 2009.

The 2009 EFP assumes that capital inflows in the form of FDI and foreign loans will remain sufficient to fully cover the foreseen current account deficit. FDI are projected to reach an average EUR 2.2 billion per annum, accounting for 37% of the current account deficit. As debt financing will remain an important part, foreign indebtedness is expected to increase by about EUR 8 billion or 9% of GDP to 73% over the programme horizon. Taking FDI and foreign borrowing together, the 2009 EFP assumes that capital inflows will reach EUR 4.7 billion per annum, while Serbia's foreign exchange reserves will remain at a level sufficient to cover six-months worth of imports of goods and services.

Overall, the external sector projections of the 2009 EFP may be on the high side as it is likely that the current account deficit and the need for foreign financing will contract faster than assumed under the programme. While FDI have been declining in recent months, foreign loans have remained available, although at shorter maturities than in the past. In addition, the Serbian authorities have secured a substantial amount of borrowing from International Financial Institutions. The resulting increase in public external debt should not be of major concern as the sovereign debt level is low and the Republic of Serbia is in fact a net external creditor. Furthermore, substantial proceeds related to the sale of oil and gas conglomerate NIS will become available during 2009. Further FDI inflows could be realized if Serbia would continue with the privatisation of remaining state-owned enterprises as foreseen under the European Integration Programme of October 2008 and the European Partnership Priorities. However, business environment improvements, including a lightening of labour related regulation and a revision of the social security systems, remain necessary if Serbia wants to continue to attract foreign investors in a much more difficult international environment.

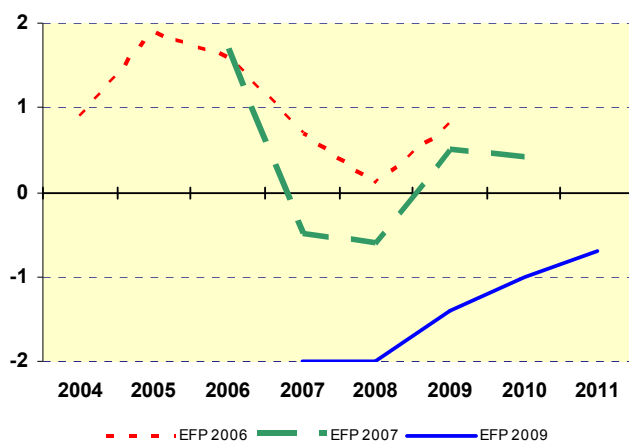
Main risks to the macro-economic scenario

The 2009 EFP correctly identifies major global and domestic risks factors to the macro-economic scenario. On global risks, the programme sees as major risk factors a further deterioration of the international financial crisis, rising costs of fuel and raw material, a prolonged and deep recession in the advanced economies, capital flight from emerging economies and deteriorating access to foreign capital. Domestic risks are seen in higher volatility of the dinar as well as a failure of the government to deliver on the planned reform and economic policy measures.

4.3. PUBLIC FINANCE

The fiscal framework of the 2009 EFP is well integrated into the overall policy objectives, and based on the presented medium-term economic framework. The programme does not refer to remarks of the Progress Reports or European Partnership priorities. The public finance framework is overall coherent and consistent. It is however not very realistic against the backdrop of the current global economic and financial crisis and its impact on Serbia. The fiscal framework could have been more comprehensive and would have benefited from a more detailed presentation of key measures on the revenue and expenditure side. The programme would also have benefited from a quantitative impact assessment of the most important fiscal measures. The presentation of fiscal risks is comprehensive; but additional information and quantification would have been helpful. The fiscal scenario rests on a not very ambitious reduction of expenditures as well as a continuation of structural reforms, in particular enterprise sector restructuring and privatisation. The programme provides a brief analysis of the exchange rate- and GDP growth-sensitivities of public debt.

Graph II.4.1: Budgetary developments (general government balance, % of GDP)



The fiscal strategy of the programme is to reduce public expenditures as a share of GDP by 0.8 percentage point over the programme horizon. It is planned to reduce current expenditures by 1.9 percentage points of GDP by a reduction in payroll expenditures, public consumption and social benefits and transfers. Capital expenditure is foreseen to grow by 1.3 percentage points of GDP. The budget balance is programmed to improve by 1.5 percentage points of GDP and to reach a deficit of 0.7% of GDP by 2011. Public revenues are projected to decrease by 0.5 percentage points over the same period. Public debt is expected to remain unchanged at 25% of GDP. Unless a swift and vigorous budget rebalancing exercise takes place, these assumptions may turn out to be unrealistic – at least as regards 2009 – given the rapid deterioration of Serbia's public finances observed in late 2008 and early 2009.

4.3.1. General government balances and debt

Actual balances and medium-term perspectives

In 2008, the consolidated budget recorded a deficit of 2.2% of GDP compared to a planned 2.7% of GDP deficit under the revised 2008 budget and a deficit of 1.9% of GDP in 2007. Fiscal policy remained expansionary, mainly driven by an increase in current expenditures which accounts for more than 90% of total expenditures and almost 40% of GDP. In particular, expenditures for public sector

Box II.4.2: Recent Fiscal Loosening

After fiscal adjustment generated a surplus in 2005 (+0.9% of GDP), the consolidated public sector entered a period of deficit in 2006 and 2007 (-1.6 and -2.0% of GDP) due to an increase in public expenditures (from 41.8% in 2005 to 45.2% of GDP in 2007). Fiscal policy became increasingly expansive after the completion of the arrangement with the International Monetary Fund in February 2006 and after the inflow of large privatisation proceeds, which enabled expenditures to be increased without significant new borrowing by the government.

Higher total expenditures resulted from a considerable increase of capital expenditures in 2006 and 2007 (from 2.7% in 2005 to 5.0% of GDP in 2007), with a simultaneous increase of current expenditures (from 38.7% in 2005 to 39.6% of GDP in 2007). In 2007, capital expenditures were 2.3 percentage points of GDP higher compared to 2005, while current expenditures increased by 0.9 percentage points of GDP during the same period.

However, higher current expenditures, in particular in categories in which a higher level of appropriations is imposed by law, create a long-term problem for public finances as they limit the scope for future savings and reduce fiscal flexibility. As a result, only capital expenditures can be reduced to realise fiscal savings.

In fact, in 2008 capital expenditures were reduced to 3.9% of GDP. At the same time, current expenditures grew to 39.8% of GDP while payroll and pension expenditures grew to 10.7% and 12.9% of GDP, respectively. In addition and not yet fully reflected in the 2008 data, public sector salaries were further increased in the course of 2008 and pensions were raised by an extraordinary 10% in November in addition to the regular 4.13% increase. The 2009 budget foresees an additional increase of general government sector salaries by 8%.

The recent trend in Serbia's public finances puts its medium-term sustainability in question and risks undermining Serbia's future growth prospects. It is therefore recommended that the Serbian authorities change course quickly and take measures to reverse the substantial increases in public sector salaries and pensions of past years. In addition, any scope for further expenditure cuts needs to be fully used. At the same time, structural reforms, in particular enterprise restructuring and privatisation needs to be put on top of the policy agenda, to cut wasteful subsidies to unviable enterprise and increase privatisation revenues.

salaries and pensions grew particularly strong (by 18% and 36%, respectively) while both categories account for more than 50% of total spending and 24% of GDP. In contrast, capital expenditures declined by 5.5% year-on-year accounting for less than 4% of total spending and 3.9% of GDP, compared to 4.9% a year-earlier. The recent trend of an increase in current spending at the expense of a reduction in capital expenditures is a source of concern as it risks putting the sustainability of Serbia's public finances into question and may undermine Serbia's future growth prospects.

The 2009 EFP budget targets for 2009 are in line with the 2009 budget law, which was adopted by parliament in January 2009, following an agreement with the IMF on a 15-months precautionary stand-by agreement. However, the presented public finance framework is based on too optimistic growth assumptions for the world and EU economies as well as for Serbia, and therefore renders the revenue and expenditure projections unrealistic. In addition, the presentation and discussion of the medium-term fiscal projections is rather descriptive and falls short of what is expected in terms of scope and depth.

The 2009 EFP acknowledges that fiscal policies of the recent past have been pro-cyclical and that policies will need to respond to the challenges for macroeconomic and fiscal stability posed by the

current global economic and fiscal crisis. The 2009 EFP identifies the curbing down of public spending as the main objective for fiscal policy over the programme horizon, to be achieved through lower current expenditures, in order to create scope for necessary infrastructure investments. The programme rightly underlines that given past fiscal policies, Serbia's room for manoeuvre to respond to the negative affects of the world economic crisis is very limited. In fact, should revenues fall short of plan, which appears likely given the optimistic growth and revenues assumptions, Serbia will need to drastically cut expenditures, to avoid that the fiscal deficit spirals turn out of control.

Keeping the above mentioned caveats in mind, the 2009 EFP envisages for 2009 an increase of consolidated public expenditures by 0.2 percentage points to 43.3% of GDP. Revenues are projected to increase by 0.8 percentage points to 41.9% of GDP, resulting in a consolidated public sector balance of -1.4% of GDP. The increase of expenditures is driven by an 8% year-on-year increase of public sector salaries and the carry-over effect of the November 2008 extraordinary 10% pension increase. The latter result in a 16.4% year-on-year increase in funds required for pension payments in 2009. Savings are foreseen to be achieved through a 0.5% of GDP reduction of subsidies, a 0.4% of GDP increase in revenues through higher excise taxes on diesel and gasoline as well as a transfer of 50% of net profits of public enterprises to the republican budget. Capital expenditures are foreseen to be increased by 0.6% of GDP to fund national important infrastructure projects, such as the Corridor 10 road and railways line. The deficit is expected to be financed through privatisation proceeds and external borrowing from International Financial Institutions, each in the order of 0.7% of GDP.

For 2010 and 2011, the 2009 EFP foresees a combined 1.0% of GDP decline in public expenditures to 42.3%, resulting in an accumulated decline of public expenditures over the programme horizon of mere 0.8% of GDP and falling substantially short of the 3 percentage point reduction of public expenditures that was announced in the National Program for the Integration of the Republic of Serbia into the European Union (EPI). Between 2008 and 2011, current expenditures are foreseen to decline by 1.9 percentage points to 37.4% of GDP, while capital expenditures are planned to increase by 1.3 percentage points to 4.4% of GDP. Payroll and pension expenditures are foreseen to gradually decline while subsidies will remain unchanged.

On the revenue side, the 2009 EFP plans for a 0.3 percentage point decline between 2009 and 2011. Over the same period, value added tax, which is the most important tax category, is projected to remain at an unchanged 11.1% of GDP. Personal and corporate income taxes are projected to remain stable or even increase to 11.1% and 1.9% of GDP, respectively. Custom duties are projected to decline by 0.6% of GDP, as a result of the voluntary implementation of the Stabilisation and Association Agreement (SAA). Overall, revenue projections seem very optimistic, considering the fast decline of imports, observed during the last quarter of 2008, and the slowing of economic activity, which is likely to continue in 2009 and perhaps even 2010.

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

	2007	2008	2009	2010	2011	Change: 2008-11
Revenues	43.2	41.1	41.9	41.6	41.6	0.5
<i>of which:</i>						
- Taxes and social security contributions	37.4	36.1	36.4	36.4	36.4	0.3
- Other (residual)	5.8	5.0	5.5	5.2	5.2	0.2
Expenditure	45.2	43.1	43.3	42.7	42.3	-0.8
<i>of which:</i>						
- Primary expenditure	23.5	21.1	21.4	21.3	21.2	0.1
<i>of which:</i>						
Gross fixed capital formation	5.0	3.1	3.7	4.1	4.4	1.3
Consumption	18.5	18.0	17.7	17.2	16.8	-1.2
Transfers & subsidies	21.0	21.4	21.0	20.5	20.0	-1.4
Other (residual)	-	-	-	-	-	-
- Interest payments	0.8	0.7	0.9	0.9	1.0	0.3
Budget balance	-2.0	-2.0	-1.4	-1.1	-0.7	1.3
Primary balance	-1.2	-1.3	-0.5	-0.2	0.3	1.6
Gross debt level	31.3	30.0	28.6	27.8	27.0	-3.0

Sources: EFP 2009 submission, ECFIN calculations

The programme correctly identifies several major risk factors which could contribute to a very fragile fiscal position as revenues could fall significantly short of plan and expenditures turn out to be substantially higher than projected. The main risks to the fiscal framework of 2009 EFP could stem from a slowdown of economic growth, lower privatisation proceeds, a decline in dividends of public enterprises, liabilities related to the deposit insurance, higher increase in current expenditures, loan guarantees given to public enterprises, an operating loss of the National Bank of Serbia, liabilities stemming from military pensions as well as costs related to possible recapitalisations of financial institutions. The 2009 EFP does not provide any quantification of these risks to public finance.

Debt levels and developments, analysis of below-the-line operations and stock-flow adjustments

The 2009 EFP projects gross public debt to continue declining to 26.9% of GDP in 2009 and to 25.2% of GDP in 2011, despite fiscal deficits over the programme horizon, assuming a continuation of strong GDP growth. This is not very realistic and in fact substantially lower GDP growth combined with a rising amount of public debt will result in an increase in gross public debt ratio. Planned borrowing for large-scale infrastructure projects, substantial financing from IFIs and a possible continuing depreciation of the exchange rate should result in a higher degree of indebtedness. The 2009 EFP does provide a basic analysis of the sensitivity of public debt to changes in the exchange rate, GDP growth and tax revenues.

At end-2008, the public debt of Serbia comprised of 65.5% and 34.5% of foreign and domestic debt, respectively. 76% of Serbian public debt is denominated in euro, 15% in US dollar, 5.2% in special drawing rights (SDR), 2.8% in other currencies and only 0.4% in Serbian dinar. As privatisation proceeds, realised during previous years, have been to a large extent spent, the Serbian authorities have started issuing domestic t-bills to finance part of the fiscal deficit during the programme horizon.

Budgetary implications of "major structural reforms"

The 2009 EFP does not provide the requested matrix on policy commitments and therefore does not include quantitative information on the budgetary impact of major structural reforms on the expenditure or revenue side.

4.3.2. Quality of public finances

The 2009 EFP foresees measures to improve the transparency of public finance and to strengthen budget and debt management. A new law on the budget system is currently under preparation with the objective of improving the transparency and efficiency of public finances. Among others, the introduction of a mid-term investment plan as part of the budget memorandum and the preparation of three-year budgets are foreseen. On expenditure control, the creation of the State Audit Institution is expected to lead to a more stringent enforcement of responsibilities and to improve public finance in general. To strengthen and modernise budget management, the establishing of a Public Debt Administration is foreseen. As far as expenditure management is concerned, already in the previous period, efforts were made to improve the connection between the budget and policy planning, with the introduction of budget programming.

Over the programme horizon, the 2009 EFP projects public expenditures to decline by 1 percentage points to 42.4% of GDP, driven by a reduction in current expenditures by 1.5 percentage points of GDP to 37.4%. Expenditure cuts stem mainly from a reduction in payroll expenditures, public consumption and social benefits and transfers. Capital expenditure is foreseen to be increased by 0.7 percentage points of GDP to 4.4%. Revenues are projected to decline only marginally by 0.3 percentage points to 41.6% of GDP. While the fiscal adjustment foreseen in the 2009 EFP is not ambitious, the intended reduction in current expenditures and increases in investment goes into the right direction. However and as already emphasised earlier in this document, the 2009 EFP rests on rather unrealistic assumptions regarding public finance developments.

4.3.3. Institutional features of public finances

The development of a comprehensive budgetary planning process is well advanced in Serbia. The law on budget system defines roles and responsibilities in the budgetary process. While a comprehensive legislative framework for public finance is in place, some elements of the existing legislation still need to be fully implemented, such as the creation of an administration for public debt management and the state audit institution. In addition, the budgetary process could be strengthened by improvements in expenditure planning, execution and control. Efforts to introduce multi-annual budgets go in the right direction.

4.4. STRUCTURAL REFORMS

The 2009 EFP presents a comprehensive structural reform framework, covering a wide range of structural policies related to the enterprise and financial sector, labour market and social welfare system, public administration and public finance management. The structural reform agenda aims to foster economic restructuring, enhance competition, stimulate employment and rationalise social spending. The programme gives sufficient space to measures to improve the overall business and entrepreneurial environment and to attract foreign investors. However, the 2009 EFP does not sufficiently address the much needed reform of the pension and health systems. The relation between the structural reform agenda and the fiscal strategy could have been stronger. The programme would have benefited from the presentation of the estimated fiscal impact of the most important structural reform measures as well as clear timetables for their implementation. The structural reform strategy is broadly supportive for the fulfilment of the Copenhagen economic criteria.

4.4.1. Product and capital markets

Restructuring and privatisation of socially-owned enterprises has significantly advanced since transition started in 2001 and it is now in its final stage. To finalise this process, amendments to the Privatisation law have been made and the deadline for privatising the remaining socially-owned enterprises has been extended to 31 December 2008. The 2009 EFP states that by the end of 2008 all tendering procedures and auctions should have been announced for the remaining companies and privatisation should be completed by mid-2009. It is unlikely that this deadline is going to be met, in particular regarding the resolution of the more difficult cases. The 2009 EFP emphasises the priority for the restructuring and privatisation of the remaining state-owned enterprises, as well as the liberalisation of the infrastructure activities in which those enterprises operate. This is correctly identified as one of the largest reform challenges for Serbia over the programme horizon. However, the government still has to define restructuring and privatisation strategies for most of the enterprises concerned. To facilitate the privatisation of the remaining state-owned enterprises, the government intends to distribute free shares of these companies, amounting to 15% of their equity, to the Serbian population, which has not benefited from any share distribution in the past. However, previously announced ambitious plans to launch IPOs for the electricity, telecom, airport and pharmaceutical companies seem to progress only slowly and may be held back by apparent lack of consensus within the government coalition.

The 2009 EFP foresees to strengthen competition policy, also in line with requirements under the SAA. The need to improve the business and investment environment is recognised and the 2009 EFP foresees to step up efforts in enacting relevant systemic laws and in enforcing their implementation. Efforts in promoting SMEs and entrepreneurship are foreseen to remain high on the government's agenda. On state aid policy, implementation is planned along the lines of the requirements under the SAA and WTO accession. The implementation of the state aid control law will provide for the establishment of an independent state aid control body, within one year of the entering into force of the SAA.

Comprehensive reform of the legislative and regulatory framework is intended to help development of the financial markets in Serbia. To help deepen capital markets it is planned to allow large utility enterprises to be listed on the stock exchange. Financial market supervisory functions of the Securities Commission are foreseen to be reinforced and reporting arrangements will be implemented based on the International Financial Reporting Standards (IFRS) and the principles of the International Organisation of Security Commissions (IOSCO). These are all welcome steps in further developing the Serbian capital market, which is needed to help diversify the financial system and contribute to greater stability.

Reform of the banking system is ongoing as the new law on banks, which is in line with relevant EU directives and standards of the Basel Committee on Banking Supervision, is being implemented. However, transition from a compliance-oriented regime to a risk-based supervision is likely to be gradual. Privatisation of the banking sector is expected to continue and the EFP foresees that the remaining government holdings in banks will be sold. As far as the non-banking financial sector is concerned, the regulatory framework of the insurance sector is planned to be further developed and the sector's supervision to be strengthened. Privatisation of the insurance sector is set to continue. The 2009 EFP also addresses reforms of the leasing sector as well as the voluntary pension and investment fund industries.

Overall, the programme could have been more pronounced on financial sector related challenges and possible policy responses, such as the adverse impact of credit and liability euroisation on monetary transmission mechanisms, the high degree of exchange rate indexation of loans and unhedged foreign exchange positions, and the high share of non-performing loans.

4.4.2. Labour market

The Serbian labour market continues to face significant challenges, such as high unemployment even adjusted for substantial hidden employment, a low participation rate, and real average wage increases above labour productivity gains, although the gap has substantially narrowed in recent years. According to the 2009 EFP the labour market strategy of Serbia envisages raising employment by boosting labour productivity through investment in human resources and completion of privatisation. A new employment law is planned to improve labour market flexibility and to facilitate partnerships between employers, job-seekers and labour market institutions. In addition, it is foreseen to strengthen the foundations for job creation through improvements of labour market institutions and harmonisation of regulations with EU and ILO standards. Unfortunately, the 2009 EFP does not aim at reducing the administrative and financial burden on employers, which was significantly increased by the application of the new labour law of July 2005.

4.4.3. Other reform areas

In addition to the above, the 2009 EFP covers several other reform areas. One particularly worth mentioning is the envisaged further reform of the social welfare system, which aims at providing a better targeting of social transfers, improved protection of the poorest citizens and needy groups and improved quality of their living. The reform programme attempts to strengthen social inclusion through capacity building and decentralisation of institutions which provide social welfare services. Funding will be provided from revenues of local governments while transfers from the republican budget will be granted to those municipalities unable to finance from their own revenues the required minimum of social welfare. The reform programme aims at strengthening participation and responsibility of the beneficiaries of social services. While this reform programme rightly aims at helping those most in need of social assistance, it would benefit from the application of a means test. The presentation of the social welfare reform would have benefited from estimates of its fiscal impact.

Regrettably, the 2009 EFP does not sufficiently address the much needed reform of the pension and health systems. The reform of both, the pension and health systems, is of high relevance to establish sustainable public finances and is a prerequisite for the reduction of social security contributions, which remain comparatively high in Serbia and are an impediment for increasing the employment rate.

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